Is Corporate Social Responsibility Priced? Evidence from Audit Pricing?

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Motivations

➢ **One motivation for this study comes from 'the fundamental importance of CSR issues in accounting research' (Moser and Martin 2012, 797)**

   ✓ **Recent CSR studies suggest that CSR performance provides value relevant information for investors and financial analysts**

      ○ **(Dhaliwal et al. 2012; Kim et al. 2012; Dhaliwal et al. 2011; Balakrishnan et al. 2011; Simnett et al. 2009).**

   ✓ However, whether CSR performance **adds value to audit firms** in their **risk assessments** and thus **audit pricing decisions** is an **underexplored area**.

➢ **Recent corporate failures (e.g., Enron, WorldCom, Lehman Brothers, Parmalat, and AIG) demonstrate that being associated with companies with poor integrity creates risks that can increase the cost of conducting the audit, lead to litigation costs and reputation damage, or even destroy of the audit firm.**

   ✓ Therefore, it is vital to understand whether audit fees are associated with CSR activities.

➢ **the recent call to investigate financial reporting quality from the perspective of managers (Hay et al. 2006)**

   ✓ because it is management who is ultimately responsible for accurate financial reporting, and the ethical value of management has a profound impact on financial reporting risk when companies face **competition** and **pressures** in the market.

Motivations (Continued)

➢ Theories on audit pricing indicate that audit fees are a function of **the cost to conduct the audit** (including a normal profit) and **perceived business risk** (**Simunic 1980; Houston et al. 1999; Houston et al. 2005**).

➢ Recent studies on audit pricing primarily focus on the effects of

  ✓ **brand name reputation** for Big N auditors, **city-level industry specialization** (**Craswell et al. 1995; Ferguson et al. 2003; Francis et al. 2005; Fung et al. 2012**),

  ✓ **audit firm office size** (**Choi et al. 2010**),

  ✓ **industry complexity** (**Francis and Seevey 2012**),

  ✓ **accounting complexity** (**Kim et al. 2012**),

  ✓ **industry investment opportunity set** (**Cahan et al. 2008**), **scale economies** (**Fung et al. 2012**),

  ✓ **internal control weaknesses** (**Hoitash et al. 2008; Raghunandan and Rama 2006; Johnston and Bedard 2008**), and

  ✓ **various internal and external governance mechanisms** (e.g., Gul and Goodwin 2010).

➢ However, **little is known** on how **managers' ethical behavior** affects **audit firms' audit pricing decisions**.

➢ In this study, we take the unique approach to focus on the **impact of managers' ethical behavior** implied by corporate social responsibilities (CSR) **on audit pricing**.

CSR Theories

➢ **Corporate culture/ethical theories of CSR**

✓ Under corporate culture theory, CSR is a **shared belief within a firm** – the belief about the **"right" course of actions** that takes into account **not only economic** but also **social, environmental and other externalized impacts of company actions (e.g., Kreps 1990)**

✓ Ethical theories suggest that CSR consciousness reflects better business ethics **(Carroll 1979; Jones 1995)**

○ Based on the notion of **"the right thing to do"** or the "necessity to contribute to the **good of society by doing what is ethically correct**"

○ **Jones (1995)** suggests that CSR firms conduct business on **the basis of trust** and have an incentive to demonstrate a **commitment to ethical behavior**.

Evidence in Support of the Corporate Culture/Ethics Implications of CSR Practices

➢ **Anecdotal evidence**

    ✓ a survey study by **Waldman et al. (2006)** based on responses from **561 firms** located in **15 countries** shows that a **CEO's integrity** affects management attitudes towards CSR.

➢ **Empirical evidence**

    ❖ **Management make more responsible corporate decisions**

        ✓ socially responsible firms are **less likely** to engage in **earnings management** (**Kim et al. 2012**)

        ✓ **good** CSR practices are associated with **lower tax aggressiveness** (**Watson 2011** and **Lanis and Richardson 2012**)

        ✓ and firms with **excessive irresponsible CSR activities** have a **higher likelihood of engaging in tax sheltering activities** and **greater discretionary/permanent book-tax differences**. (**Hoi et al. 2013 TAR**)

        ✓ **better CSR performance** are likely to have **higher internal control quality** (**Guo et al. 2012**)

    ❖ **Good CSR performance** can also **signal to stakeholders the integrity of the underlying management team** (**Godfrey et al. 2009**; Vitell and Paolillo 2004; Waldman et al. 2006).

Opportunistic Perspective of CSR Activities

➤ **McWilliams et al. (2006)** argue that CSR is a **managerial perquisite**, i.e., managers use CSR to **advance their careers** or **fulfill other personal agendas**.

➤ **Hemingway and Maclagan (2004)** assert that managers' personal benefits could be driving CSR.

❖ **Empirical evidence:**

✓ management may use their discretionary decisions to engage in CSR strategically to **meet earnings benchmarks** (Petrovits 2006; Prior, Surroca, and Tribo 2008),

✓ to **cover up corporate/management misconduct** (e.g., Hemingway and Maclagan 2004; McWilliams et al. 2006),

✓ to **offset corporate social irresponsibility** (Muller and Kraussel 2011; Kotchen and Moon 2011), or

○ when firms do more "harm", they also do more "good"

✓ to **enhance its CSR reputation** – to protect the firm against the risk of adverse political, regulatory, and social sanctions/penalties in the case of negative corporate events (Godfrey 2005; Minor and Morgan 2011).

Hypotheses Development

➢ If CSR exhibits management's 'ethical concerns' and corporate culture in their strategic decisions – a signal for **FRR** ⬇ the **engagement risk** ⬇ audit efforts ⬇ audit fees

➢ If *CSR* represents management's opportunistic behavior to 'window-dress' the financial position , then it would increase the possibility that the financial statements would contain material misstatement (**higher *FRR*)** ⬆ the **engagement risk** ⬆ audit efforts ⬆ Audit fees

✓ *H1a (Ethical Perspective Hypothesis): Audit fees are* *negatively related with CSR activities.*

✓ *H1b(Opportunistic Perspective Hypothesis): Audit fees are* *positively related with CSR activities.*

Research Design

➤ **CSR and Audit Pricing**

❖ $LAF_{i,t} = \beta_0 + \beta_1 CSR6_{i,t} + \beta_2 CGOV_{i,t} + \sum_{\beta=3}^{N=16} Controls_{i,t} + \beta_j IndustryDummies + \beta_k YearDummies + \varepsilon_{14}$

✓ Control variables include: *LAT, LSEG, Foreign, CATA, QUICK, DE, LOSS, Restatement, YE, OfficeSize, Scale, Influence, CIS*

✓ *CSR6* = net score of CSR ratings, measured as total strengths minus total concerns in six social rating categories of KLD ratings data: community, diversity, employee relations, environment, product, and human rights;

Databases

➢ **Accounting data** – **Compustat**

➢ **Auditor data** – **Audit Analytics**

➢ **CSR score** – **MSCI ESG research** (formerly called **KLD** database)

  ✓ 650 firms in 1991 with annual ratings (including S&P 500 and Domini 400 Social Index)

  ✓ 1,100 firms in 2001 and

  ✓ 3,100 firms in 2003 (include firms from Russell 1000 and 2000 indexes as well as from certain social indexes)

    ❖ Qualitative Issue Areas - Product, Diversity, Employee Relation, Community, Environment, Human Rights,

Table 1

Sample Selection

Criteria	N
Firm-year observations with the intersection between the Audit Analytics database, and thke Compustat database for the period 2000 to 2009 with auditors identified	27,385
Less observations:	
Missing MSCI data to calculate CSR measures	(6,075)
Missing stock prices	(151)
Missing control variables	(5,889)
Final Sample – Firm-year observations	15,270

Table 2
Descriptive Statistics

Variables	N	MEAN	STD	Q1	MEDIAN	Q3
LAF	15,270	7.096	1.058	6.378	7.034	7.752
CSR6	15,270	-0.325	1.939	-1.000	0.000	1.000
CGOV	15,270	-0.235	0.705	-1.000	0.000	0.000
LAT	15,270	6.958	1.610	5.769	6.800	7.964
LSEG	15,270	0.976	0.406	0.693	0.693	1.386
FOREIGN	15,270	0.544	0.498	0.000	1.000	1.000
CATA	15,270	0.468	0.238	0.279	0.462	0.648
QUICK	15,270	2.258	2.328	0.961	1.477	2.551
DE	15,270	0.497	0.243	0.312	0.493	0.652
LOSS	15,270	0.165	0.371	0.000	0.000	0.000
Restatement	15,270	0.149	0.356	0.000	0.000	0.000
YE	15,270	0.700	0.458	0.000	1.000	1.000
OfficeSize	15,270	17.236	1.388	16.346	17.441	18.233
Scale	15,270	0.810	0.237	0.636	1.000	1.000
Influence	15,270	0.107	0.181	0.013	0.037	0.106
CIS	15,270	0.262	0.440	0.000	0.000	1.000

Table 3

Correlation Table

Variable		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
LAF	1		0.020	-0.374	0.700	0.082	0.356	-0.221	-0.311	0.370	-0.228	-0.010	0.086	0.318	-0.036	0.380	0.164
CSR6	2	0.062		-0.056	0.064	-0.017	0.113	0.066	0.058	-0.073	-0.020	-0.018	-0.057	0.079	-0.059	-0.047	0.035
CGOV	3	-0.375	-0.039		-0.395	-0.035	-0.171	0.076	0.102	-0.138	0.087	0.039	0.020	-0.154	0.048	-0.126	-0.065
LAT	4	0.732	0.088	-0.386		0.056	0.194	-0.482	-0.464	0.463	-0.336	-0.015	0.061	0.131	0.030	0.374	0.159
LSEG	5	0.087	-0.019	-0.037	0.058		0.031	-0.046	-0.028	0.032	-0.037	-0.022	0.035	0.024	0.019	0.036	0.008
FOREIGN	6	0.352	0.128	-0.167	0.187	0.032		0.129	0.067	-0.054	-0.150	0.000	-0.068	0.159	-0.119	0.111	0.038
CATA	7	-0.225	0.066	0.082	-0.478	-0.046	0.120		0.547	-0.398	0.243	-0.008	-0.167	0.051	-0.065	-0.198	-0.041
QUICK	8	-0.327	0.016	0.108	-0.387	-0.038	-0.057	0.489		-0.625	0.269	-0.019	-0.004	0.030	-0.158	-0.241	-0.055
DE	9	0.336	-0.069	-0.140	0.385	0.024	-0.061	-0.361	-0.501		-0.120	0.008	0.137	0.025	0.097	0.226	0.087
LOSS	10	-0.221	-0.027	0.083	-0.326	-0.034	-0.150	0.258	0.326	-0.083		-0.002	0.039	0.006	-0.124	-0.164	-0.009
Restatement	11	-0.010	-0.017	0.038	-0.015	-0.022	0.000	-0.009	-0.022	0.003	-0.002		-0.015	-0.011	-0.004	-0.007	0.015
YE	12	0.095	-0.067	0.017	0.068	0.039	-0.068	-0.156	0.004	0.137	0.039	-0.015		0.027	-0.056	0.026	0.055
OfficeSize	13	0.357	0.083	-0.165	0.173	0.028	0.165	0.038	-0.007	0.045	-0.008	-0.006	0.027		-0.384	-0.695	0.073
Scale	14	-0.053	-0.062	0.048	0.001	0.011	-0.123	-0.053	-0.087	0.078	-0.100	-0.006	-0.053	-0.365		0.318	-0.127
Influence	15	0.217	-0.012	-0.066	0.241	0.011	0.034	-0.124	-0.126	0.133	-0.083	0.004	0.035	-0.598	0.235		0.047
CIS	16	0.177	0.040	-0.066	0.169	0.008	0.038	-0.038	-0.040	0.079	-0.009	0.015	0.055	0.090	-0.106	0.005	

Table 4
Multiple Regression of Audit Fees on CSR

Variable	Expected Sign	Pooled Estimate		Strength Estimate		Concern Estimate	
N		15,270	***	4,005	***	7,409	***
AdjRsq		0.797	***	0.846	***	0.779	***
Intercept		-0.333	**	-0.578	***	-0.309	*
CSR6	?	-0.011	***	0.005		-0.031	***
CGOV	?	-0.028	***	-0.021	*	-0.038	***
LAT	+	0.423	***	0.437	***	0.409	***
LSEG	+	0.024	**	0.027		0.024	*
FOREIGN	+	0.252	***	0.270	***	0.234	***
CATA	+	0.426	***	0.395	***	0.399	***
QUICK	-	-0.047	***	-0.057	***	-0.042	***
DE	+	0.260	***	0.268	***	0.272	***
LOSS	+	0.099	***	0.054	**	0.129	***
Restatement	+	0.067	***	0.102	***	0.058	***
YE	+	0.089	***	0.074	***	0.047	***
OfficeSize	+	0.236	***	0.234	***	0.241	***
Scale	-	-0.049	***	-0.033	**	-0.055	***
Influence	+	1.445	***	1.406	***	1.496	***
CIS	+	0.090	***	0.069	***	0.110	***
FixedEffects Included		Yes		Yes		Yes	

Additional Analyses

➤ **Alternative measure of CSR** – *CSR5*

➤ **With additional controls:** *M&A, AA, GC, INVEC, OCFvol, Salevol,* and *Evol, BigN, ISSUE, Growth,* and *MTB, ReportLag, AC, T, Age, IOR, Nanalysts, StockRating, DebtRating, SOX404, ICMW*

➤ *CSR* **Dimensions**

✓ We find **negative and significant coefficients** on **CSR_ENV, CSR_HUM, CSR_EMP**, but **positive and significant coefficients** on **CSR_COM** , **CSR_PRO, CSR_DIV** .

Additional Analyses (Continued)

➤ Self-selection correction

- ✓ **Heckman's (1979) two-step procedure**. Specifically, we model the decision to engage in CSR activities based on slack resource theory and good management theory.

$$PR(dumCSR_{it}=1) = \alpha_0 + \alpha_1 ROA_{it} + \alpha_2 IOR_{it} + \alpha_3 NAnalysts_{it} + \alpha_4 OptionRatio_{it} + \alpha_5 absTACC_{it} + \alpha_6 MTB_{it}$$
$$+ \alpha_7 CGOV_{it} + \alpha_8 LAT_{it} + \alpha_9 LSEG_{it} + \alpha_{10} FOREIGN_{it} + \beta_{11} CATA_{it} + \alpha_{12} QUICK_{it}$$
$$+ \alpha_{13} DE_{it} - + \alpha_{14} LOSS_{it} + \alpha_{15} Restatement_{it} + \alpha_{16} YE_{it} + \alpha_{17} OfficeSize_{it} + \beta_{18} Scale_{it}$$
$$+ \alpha_{19} Influence_{it} + \alpha_{20} Growth_{it} + \alpha_{21} \Delta LOSS_{it} + + \beta_j IndDummies + \beta_k YearDummies + \varepsilon \qquad (2)$$

➤ Propensity Score Matching

$$CSR_{it} = \alpha + \beta_1 MTB_{it} + \beta_2 LogMV_{it} + \beta_3 R\&D_{it} + \beta_4 Loss_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \beta_7 FCF_{it}$$
$$+ \beta_8 IOR_{it} + \beta_9 Nanalysts_{it} + \beta_{10} Age_{it} + \beta_{11} MarketShare_{it} + \beta_j IndDummies$$
$$+ \beta_k YearDummies + \varepsilon \qquad (3)$$

Table 5
Multiple Regression of Audit Fees on CSR – Alternative Measure (*CSR5*)

	Expected Sign	Pooled		Strength		Concern	
		Estimate		Estimate		Estimate	
N		15,270	***	4,005	***	7,409	***
AdjRsq		0.797	***	0.846	***	0.779	***
Intercept		-0.330	**	-0.559	***	-0.314	*
CSR5	?	-0.008	***	0.008	*	-0.027	***
CGOV	?	-0.028	***	-0.022	*	-0.038	***
LAT	+	0.423	***	0.435	***	0.411	***
LSEG	+	0.024	***	0.027		0.025	*
FOREIGN	+	0.252	***	0.271	***	0.235	***
CATA	+	0.426	***	0.390	***	0.402	***
QUICK	-	-0.047	***	-0.057	***	-0.042	***
DE	+	0.261	***	0.268	***	0.273	***
LOSS	+	0.100	***	0.054	**	0.129	***
Restatement	+	0.067	***	0.102	***	0.058	***
YE	+	0.089	***	0.075	***	0.047	***
OfficeSize	+	0.236	***	0.233	***	0.241	***
Scale	-	-0.049	***	-0.033	***	-0.055	***
Influence	+	1.445	***	1.405	***	1.500	***
CIS	+	0.090	***	0.068	***	0.110	***
FixedEffects Included		Yes		Yes		Yes	

Table 7
Multiple Regression of Audit Fees on CSR - Self-Selection Correction

	Expected Sign	Pooled Estimate		Strength Estimate		Concern Estimate	
N		15,136	***	3,991	***	7,336	***
AdjRsq		0.799	***	0.848	***	0.779	***
Intercept		-1.395	***	-1.821	***	-1.353	***
CSR6	?	-0.007	***	0.006		-0.027	***
CGOV	?	-0.029	***	-0.025	**	-0.038	***
LAT	+	0.487	***	0.511	***	0.461	***
LSEG	+	0.013		0.012		0.015	
FOREIGN	+	0.295	***	0.318	***	0.269	***
CATA	+	0.610	***	0.586	***	0.557	***
QUICK	-	-0.050	***	-0.062	***	-0.044	***
DE	+	0.175	***	0.161	***	0.209	***
LOSS	+	0.124	***	0.070	***	0.151	***
Restatement	+	0.037	***	0.067	***	0.031	*
YE	+	0.059	***	0.037	**	0.024	
OfficeSize	+	0.240	***	0.233	***	0.251	***
scale	-	-0.024	***	0.000		-0.038	***
Influence	+	1.437	***	1.365	***	1.515	***
CIS	+	0.086	***	0.065	***	0.104	***
IMR	?	0.463	***	0.528	***	0.402	***
FixedEffects Included		Yes		Yes		Yes	

Table 8

Multiple Regression of Audit Fees on CSR - Propensity Score Matching

Panel B: Regression Analysis

Variable	Matched Sample Estimate		Strengths Firms Estimate		Concerns Firms Estimate	
N	7,424	***	3,712	***	3,712	***
AdjRsq	0.820	***	0.835	***	0.811	***
Intercept	-0.469	***	-0.295	*	-0.547	***
CSR6	-0.005	**	0.005		-0.029	***
CGOV	-0.031	***	-0.020		-0.054	***
logAT	0.430	***	0.440	***	0.405	***
LSEG	0.007		0.027		-0.013	
FOREIGN	0.270	***	0.268	***	0.274	***
CATA	0.459	***	0.393	***	0.456	***
QUICK	-0.053	***	-0.057	***	-0.049	***
DE	0.311	***	0.277	***	0.327	***
LOSS	0.067	***	0.051	*	0.086	***
Restatement	0.061	***	0.095	***	0.038	
YE	0.096	***	0.060	***	0.141	***
OfficeSize	0.233	***	0.217	***	0.248	***
Scale	-0.045	***	-0.030	**	-0.056	***
Influence	1.439	***	1.335	***	1.547	***
CIS	0.092	***	0.075	***	0.103	***

TABLE 9
Multiple Regression of Audit Fees on CSR Dimensions

Variable	Expected Sign	Model 1		Model2		Model3		Model 4		Model 5		Model 6		Model 7	
		Estimate		Estimate		Estimate		Estimate		Estimate		Estimate		Estimate	
N		15,241		15,241		15,241		15,241		15,241		15,241		15,241	
AdjRsq		0.798		0.798		0.798		0.798		0.798		0.798		0.800	
Intercept	?	-0.184		-0.171		-0.155		-0.139		-0.138		-0.232		-0.090	
CSR_ENV	?	-0.020	***					-0.045	***					-0.015	**
CSR_COM	?			0.031	***									0.038	***
CSR_HUM	?					-0.104	***							-0.087	***
CSR_PRO	?							0.023	**					-0.034	***
CSR_DIV	?									0.013	***			0.015	***
CSR_EMP	?											-0.042	***	-0.042	***
CGOV	?	-0.027	***	-0.029	***	-0.027	***	-0.028	***	-0.028	***	-0.027	***	-0.029	***

Contributions

➢ **First, our study adds to research that investigates the determinants of audit pricing.**

✓ Our Study is among the first attempt to examine how managers' ethical behavior implied in CSR performance is factored into audit pricing and how it affects audit outcomes (Koh and Tong 2013; Chen et al. 2012).

➢ **Second**, this study extends recent CSR studies suggesting CSR disclosures provide **value relevant information** (more transparent and reliable) from an investor's perspective to **an auditor's perspective**.

➢ **Finally**, our study suggests that **corporate ethical behavior is desirable** since it translates into **economic benefits** in terms of lower assurance fees for audit services.