Business Challenges in Changing Environment and its Financial Implications for CSR

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The implications for Corporate Social Responsibility (CSR) due to changing global corporate environment are a serious issue for all the stakeholders. The global financial crisis necessitated the way corporations has catalyzed and focus towards sustainability. The paper critically evaluates the literature on the relationship between CSR and financial reporting, earnings management, capital structure, cost of capital and tax avoidance from theoretical and empirical viewpoints. The conclusion discusses future research gaps in the field from a global perspective.

Keywords: Corporate Social Responsibility, Stakeholders, Earnings Management, Tax avoidance, Capital structure

1. Introduction

In dynamic economic environment, corporations can no longer act as isolated economic entities operating in detachment from the society. The traditional view of competitiveness, survival and profit are becoming redundant (IISD, 2019). This has led to growth in demand for greater disclosure, increased customer interest and investor pressure leading to the exploration of voluntary and non-voluntary initiatives in disclosing social and environmental objectives. The financial crisis of 2008 has highlighted the need for corporations to help the government in developing sound policy and regulatory frame works. In this changing era, all the development challenges are positively correlated with corporate challenges. A few decades ago, major developmental challenge was only economic disparity i.e. transforming the lives of people in poorer countries to reach the standard of those who are living in developed countries. Despite advancements in emerging economies underdevelopment in urban and rural areas is a challenge for economies. The participation of corporations to the economic development is through the corporate social responsibility (CSR). CSR may not solve all economic challenges being faced by corporations but by investing in areas like research and development, community relations, etc it can give just the right push to make the world a better place to live in. Academic interest in social responsibility of business has grown significantly over the years on variety of topics related to finance and economics like impact of role of board and foreign ownership, firm debt maturity, credit rating, stock returns on CSR. Several management theories assume that an objective of a corporation is to maximize its profit subject to constraints where shareholder act as a key agent by providing the financial resources for the firm's operations (Jensen and Meckling, 1976; Zingales, 2000).However, there are two schools of thought existing among scholars on meeting the need of the stakeholders, "by doing well by doing good" (Porter and Kramer, 2011).The corporation creates value for shareholders by avoiding situations like consumer boycotts and paying fines to the government. In contrast, another group of scholars debate that adopting environment and social policies can destroy shareholder wealth (Friedman, 1970, Navarro, 1988). Their argument is similar to Jensen and Meckling (1976) that sustainability implies an agency cost. The 'stakeholder approach' is gaining momentum and is replacing the 'shareholder value' to curb the challenges being faced by the corporations. The late 1990s came up with the concept of triple bottom line by Eklington (1997) which focusses not only on economic value that the corporations can add, but also on the environmental and social value that they add or destroy. Goran Svensson (2018) found from their cross-industrial studies in Norway and Spain that the triple bottom line's economic element has a direct effect on the environmental element with the social element mediating this effect.

One of the most debated topics about CSR is the relationship between corporate social performance (CSP) and corporate financial performance (CFP). For more than forty years, the link between CSP and CFP is still not established clearly. Margolis et al. (2009) collected more than 200 studies on this question in their meta-analysis and observed that 59% of these studies revealed the non-significant relationship, 2% negative relationship and 28% a positive relationship. There is a need to extend our comprehension of the implications of CSR. Stakeholders wish to know whether CSR can affect methodology of howa firm manages earnings, risk and financing decisions. The CSR-CFP relationship in the literature has led to the development and the emergence of other avenues of research. These arguments encourage an important body of literature that includes the impact of CSR on earnings management (Chih et al; 2008; Yip et al; 2011; Kim et al; 2012), financial reporting (Andrikopouloset al, 2014, Carey, Liu &Qu, 2017) cost of capital and capital structure (Ng and Razaee et al, 2015, Girerd-Potin et al 2011) and tax-avoidance (Huseynov & Klamm (2012), Preusse (2010).

In this paper, we present a literature review on the firm's financial implications in relation to CSR. We discuss the theoretical and empirical viewpoints on the impact of CSR on financial reporting, earnings quality, tax avoidance and cost of capital and capital structure. The qualitative assessments of empirical results provide an overview of current research and directions for future research.

2. CSR and Financial Reporting

Arguments persist as to how companies have adopted CSR into their financial reporting to project a high audit quality standard as compare to companies that have not adopted CSR. There is a perception that positive image flows to company's reputation, such as less financials risk and high earning. Existing literature on testing this hypothesis reveals that the way CSR is reported has changed during the recession by becoming a mechanism by which companies can survive. After the recession, the business sector has made limited progress in truly integrating CSR into core business activities (Ellis &Bastin, 2010).Andrikopoulos et al. (2014) found that the extent of disclosure of CSR practices is greater in larger companies and also in companies that have high financial leverage. The significant properties of the disclosure are not related to its quantity, but it's content. Patten & Zhao (2014) argued with Guthrie et al (2008) analysis that the companies in their sample focus more on discussing programs and initiatives than on providing relevant performance data. Environment disclosures on an average were the most prominent CSP reporting issue. The socially responsible mutual fund stock holdings of report-issuing firms increased following the first time release of the standalone report but that the change was not statistically significant. Ballou et al. (2018) noted that CSR assurance improves CSR reporting quality by identifying inaccuracies in prior reports and improvements to definitions, scopes and methodologies that require restatements for comparability.

Accounting providers are not more likely to identify reporting inaccuracies but they do promptly prevent future inaccuracies. They also report that adopting CSR reporting frameworks like Global reporting initiative (GRI) is not a substitute for obtaining CSR assurance in terms of improving reporting quality. It can help to enhance CSR reporting quality through prompting non-error restatements. Tschopp & Huefner, R (2014) used Carnegie and Napier's seven factors (Period, Places, People, Practices, Propagation, Products and Profession) that allow for a systematic comparison between the evolution of financial reporting and CSR reporting. Financial reporting has evolved over the last 100 years but still, there are limitations within existing standards. Relative to this, CSR reporting is still in its infancy. They argued that the GRI G4 is the most widely used method of CSR reporting, but still merely two-third of reporting companies in the KPMG survey do not use this standard which makes it difficult to compare various CSR reports (KPMG, 2017). In terms of products and practices, some attempts are happening towards CSR reporting harmonization but there are opponents to it which says that one standard does not meet the needs of all stakeholders. The profession factor recognized that major CSR organizations appear to be more interconnected and supportive of one another. The propagation factor demonstrated that external organizations and bodies have played a key role in promoting and legitimizing financial reporting on CSR related issues whose goals included sustainable development. IFRS has almost become the global standard in financial reporting but a lot of work has to be done before CSR reporting is accepted on a global scale (Tschopp and Huefner, 2014). The people factor highlights that the number of stakeholders has evolved in the process.

Table 1 *Financial reporting: Variables, Issues, Relationship, Evidence*

Variables	Issues	Relationship	Evidence	Reference
Corporate social responsibility disclosure index (CSRDI)	Firm profitability, size, leverage and market to book ratio impact on disclosure	Positive relation with all four factors	Disclosure is greater in large companies and companies withhigher financial leverage.	Andrikopoulos et al. (2014)
Standalone CSR reporting	US retail industry	Positive and negative effect of such reporting on reputation	Only public limited companies disclose. Reports are more about image enhancement than transparent accountability.	Pattenx& Zhao (2014) Michelon et al (2015)
Reporting evolution	Period, Place, People, Practices, Propagation, Products & Profession	Diversified reporting	Evolution to market based reporting	Tschopp and Huefner,(2014)
Assurance	CSR assurance improves reporting quality	Positive effect	CSR assurance identifies inaccuracies in prior reports and provides improvements	Ballou et al (2018)
Estimation model	Impact of mandatory CSR reporting	Mandatory CSR constrain earnings management	Mandatory CSR disclosure mitigates information asymmetry	Wang et al (2016)

Wang et al. (2016) analyzed another dimension of this aspect that mandatory CSR disclosure firms constrain earnings management which suggests that mandatory CSR disclosure mitigates information asymmetry by improving financial reporting quality. Carey et al. (2017) support the audit-risk perspective in explaining the positive association between voluntary CSR disclosure and higher audit fees in China which is more significant for non-state owned enterprises, indicating that CSR reporting by such firms is used more as a mechanism to create the appearance of legitimacy and integrity, rather

than a honest expression of commitment to stakeholders. Those firms which issue stand-alone CSR reports were associated with more earnings management. Michelon et al.(2015)'s results indicated that the use of CSR reporting practices is not related to high disclosure quality implying that these practices are symbolic, rather than substantive. But, the companies which follow GRI guidelines and those companies which are conditional on reporting information on results (usually bigger companies with more active stakeholder engagement processes) are providing more complete information.

3. CSR and Earnings Quality

Like relationship between CSR and financial reporting, different opinion on the relationship between CSR and earning quality and management prevail. Corporate transparency and accountability are very important issue for stakeholders. Earnings quality can provide useful information about the financial performance of firms (Dechow et al., 2010). As we know that, earnings management occurs when managers start using judgment in financial reporting. We analyze the CSR and earnings management relation in the forthcoming discussion by analyzing recent studies by the scholars on same area.

Grougiou et al. (2014) addressed that in US banks, there is no bi-directional relationship between CSR and earnings management (EM). CSR is driven by EM while CSR engagement does not affect EM. Gras-Gil et al. (2016) stated that in Spain, 100 most reputable companies of Merco Index showed a negative relation of CSR with EM. Also, the firms which were more committed to CSR were less engaged in EM.Liu et al. (2017) examined how family involvement in the ownership management or governance of business affects its engagement both directly and indirectly through its CSR activities. They found that CSR is not significantly associated with both real and accrual -based earnings management behavior after accounting for the effect of family involvement. It reveals that scholars have not found any positive relationship between CSR and EM when they took family involvement as variable in their respective study.Alipour et al. (2019) found consistent results with Hong & Anderson (2011) that CSR is related to higher accruals quality and confirms ethical behavioral theory in Iran. Their study was in line with a strategic view that defines a positive relationship between environmental quality disclosure and earnings persistence.

Table 2 *Earnings Quality: Variables, Issues, Relationship, Evidence*

Variables	**Issues**	**Relationship**	**Evidence**	**Reference**
Loan Loss Provisions deflated by total loans, Realized security gains and losses deflated by total assets	Bi-directional relationship between CSR and earnings management	EM and CSR=Positive relation CSR and EM=Negative relation	Legitimacy theory. Differentiation strategy	Grougiou et al (2014)
Discretionary (Abnormal accruals)	CSR and earnings management	Negative impact	Effective use of resources	Gras-Gil et al (2016) Almaharog et al (2018) Litt et al (2014)
Discretionary accruals	Influence of corporate governance on CSR & EM	Positive impact	CSR disclosure covers up EM practices.	Suyono et al (2018), Muttakin et al (2018)
Accrual based earnings management (AEM) Real earnings management (REM)	Family involvement in the ownership	Family firms= Less AEM REM= No significant relationship	If family involvement is controlled, CSR impact is nil	Liu et al (2017)
Earnings persistence	CSR practices enhances earnings quality	Positive relation	More socially responsible banks have more earnings quality in a stricter environment.	Garcia et al (2017)
Unbiased forecast	CSR & earnings forecast	Positive relation	High CSR quality makes earnings forecast unbiased	Becchetti et al (2013)
Earnings smoothening, earnings aggressiveness, earnings losses avoidance	CSE and earnings characteristic	Negative relations	Commitment to CSR improves earnings characteristics	Chih et al (2008)

Ben Amar et al(2018) analyzed 119 French non-financial companies from 2010-2014 and found a negative impact of CSR on EM in line with the results of Litt et al. (2014), Almahrog et al. (2018) reported on labour relation that the fairness of practice and community involvement did not influence EM. Moreover, corporate governance, respect for human rights, good environmental management and meeting consumer expectations all have significant negative impacts on earnings management. In addition, Muutakin et al. (2015) concluded results in consent to the stakeholder theory with their sample of 135 companies listed on Dhaka stock exchange that a firm is influenced by different stakeholder groups in the society and reports its activities accordingly through CSR disclosures. Sial et al. (2018) reported that earnings management has a negative moderate relationship between CSR and firm performance. A high value of earnings management, which results in a high level of symbolic CSR, converts to low firm performance of the Chinese firms. CSR actions promoted by managers as a

means to cover their profit management incite an adverse effect on the company's performance. Suyono, (2018) through their sample of manufacturing companies on Indonesian stock exchange found that institutional ownership, managerial ownership and independent boards have a significant deterrent effect on earnings management. There was a strong moderation effect on earnings management and a positive link between governance and CSR. Bona Sanchez et al. (2017) stated a positive relationship between sustainability reporting and earnings in formativeness as the dominant owner's voting-cash flow wedge increases. Becchetti et al. (2013) demonstrated that high CSR quality in terms of accounting transparency, high corporate governance quality, stakeholder risk mitigation and absence of over-investment contributes to making earnings forecasts unbiased in the US. Bozzolan et al. (2015) provided evidence that CSR is negatively associated with the use of earnings management strategies in an international setting. CSR orientation of the firms interacts with the characteristics of the institutional environment such as legal enforcement in shaping the reporting incentives in a global context. Lars Moratis& Max Van Egmond (2018) findings show a positive insignificant relationship between CSR and EM from 2003-2009 in US-listed companies. Firms in industries that have a high environmental impact tend to have higher levels of CSR performance, these firms practice EM to a lesser extent than firms in industries that have a lower environmental impact (Chih et al. 2008; Kim et al. 2012).

Garcia et al. (2017) reported that CSR activities improve the bank's earnings quality. Ethics, reputation, and financial performance motivations justify the positive influence of CSR activities on banks' earnings quality. Thus, socially responsible banks committed to a higher level of CSR practices are likely to provide investors and debt holders with persistent disclosure of earnings and figures that allow managers to predict future cash flows. To conclude, scholars have no consensus among positive or negative relationship between CSR and Earnings Quality and Management based on different variables taken into account as an evidence for analysis purpose.

4. CSR and Cost of Capital and Capital Structure

Literature on the relationship between CSR and capital structure relationship show mixed reaction among scholars. Richardson and Welker (2001) made an early attempt to see the social disclosure impact on the cost of capital with their sample of Canadian firms and found a statistically significant and positive relationship between the level of social disclosure and the cost of capital for the firm but they were unclear about their results due to the period of study and biases in social disclosures. Sherfman and Fernando (2008) predicted that the market would reward the firm's improved risk position through lowered costs of debt and equity capital and provides theoretical arguments that why a firm that engages in environmental risk management experiences enhancement in cost of debt and equity capital. The cost increase is partially offset by higher tax benefits but net results are the same. Three reasons for this contrary result are punishing firms engaging in investments in environmental risk management more than compliance requirements, difficulty in separation of the effect on the cost of debt of high leverage from that of high environmental risk management as more debt is offered to companies with high environmental risk management and also there is a little demand for debt from socially screened investors (Mackey et al, 2007). Ng & Rezaee (2015) examined the effect of different dimensions of business sustainability performance on the cost of equity. They found that economic sustainability performance pertaining to growth opportunities and research efforts are negatively and significantly related to cost of equity capital while operational efficiency is positively associated with cost of equity capital. Their paper also tested interactive effects between economic and ESG (Environment, Social and Governance) sustainability performance on cost of equity and found that the relation between economic performance and cost of equity is strengthened when ESG sustainability performance is strong, but the relationship is mainly contributed by social sustainability performance. Dhaliwal et al (2011) findings indicate that the firms with high cost of capital in the previous year tend to initiate disclosure of CSR activities in the current year and the firms with CSR performance superior to its industry peers enjoy a reduction in the cost of capital after they initiate CSR reports. Further, firms initiating CSR disclosure with superior CSR performance attract dedicated institutional investors and analyst coverage, and these analysts achieve lower absolute forecast errors and dispersion following such disclosure.

Suto & Takehara, (2017) found insufficient evidence of negative link between the level of corporate social performance (CSP) and the cost of equity. Yang et al (2018) found that the effect of CSR on leverage is slow; creditors are willing to tolerate firms that deviate from their target capital structure, especially above- target leverage firms. The firms that issue CSR statements exhibit slower capital structure adjustment, and that above-target leverage firms that issue CSR statements have lower incentives than below-target leverage firms to return to the target leverage and CSR statements improve long-term leverage but do not affect short-term leverage. Bae et al (2011) supported to Maksimovic and Titman (1991), that the stakeholders are reluctant to do business with a highly levered firm because it can effect in honoring the implicit contracts with them. Girerd-Potin et al. (2011) also found no relationship between the firm’s social score and its cost of debt, suggesting that banks do not adjust their interest rates to firm social ratings. They show that debt financing is a way for firms with low social commitment on the firms cost of capital. Harjoto and Jo (2014) with their sample of US public firms found that overall CSR intensities reduce analyst dispersion of earnings forecast, volatility of stock return and cost of capital (COC), and increase firm value. However, its impact is reduced for firms with better accounting and disclosure quality. The legal (normative) CSR decreases analysts’ dispersion, stock return volatility, and COC, while legal (normative) CSR increases firm value. Most of the studies on this area reveal negative relationship between CSR and Cost of Capital and Capital Structure.

Table 3 *Cost of Capital & Capital structure: Variables, Issues, Relationship and Evidence*

Variables	Issues	Relationship	Evidence	Reference
Book value of equity, forecasted return on equity, terminal value, earnings forecasts, ROE	Financial & social disclosure & the cost of equity capital	Significant positive relation between social disclosures & cost of equity capital	Negatively related to cost of equity capital for firms with low analyst following	Richardson &Welkar (2001)
CAPM, marginal cost of borrowing	Environmental risk management & the cost of capital	Negative relation	Firms benefit from environmental risk management as they shift from equity to debt & have tax benefits	Sherfman and Fernando (2008) Suto&Takehara, (2017)
Implied cost of equity capital, market price and dividend	Voluntary disclosure of CSR activities	High cost of equity capital in the previous year= More disclosure of CSR activities	CSR is associated with a higher prior year cost of equity capital	Dhaliwal et al (2011)
Equity premium	legal & normative CSR on the analyst's earning forecast dispersion , stock return volatility, cost of equity capital & Cost of capital	Negative relation	CSR intensities increases firm value.	Harjoto and Jo (2014)
Expected return model	Impact of dimensions of sustainability performance on cost of equity capital	Negative relation	Reduced cost of capital improves financial & non-financial sustainability	Ng &Rezaee (2015)

5. CSR and Tax Avoidance

Generally, there is perception among stakeholders that CSR reduces tax avoidance. The decrease in tax expense can be viewed as an increase in profitability but tax avoidance can also be viewed as social irresponsibility as a firm is not giving its contribution to support government social programs. Huseynov & Klamm (2012) were the first to study empirically tax avoidance, tax management and CSR literature. By separating the strengths and concerns for each CSR measure, they found that the interaction of community concerns with tax management fees positively affects both GAAP and Cash effective tax rate (ETR), while the interaction of corporate governance strengths and diversity concerns with tax management fees negatively affects Cash ETR. They also concluded that additional evidence that CSR affects tax avoidance when we divide firms into portfolios based on CSR levels. Dowling (2013) started a debate in mainstream business ethics literature about the fundamental assumptions and boundary conditions of CSR in the context of tax avoidance by asking questions like do advocates of CSR truly want companies to blindly adhere to government policy? Hasseldine & Morris, (2013) is a response to the study of Sikka, P (2010) paper on "Smoke and Mirrors: Corporate Social Responsibility and Tax Avoidance" by explaining the importance of distinguishing the terms "tax evasion" and "tax avoidance" in context of CSR arguing that some firms that claim to be socially responsible are also engaged in tax avoidance similar to Preusse (2010). Laguir, Staglianò & Elbaz, (2015) used a structured model using partial least squares regression and measured tax aggressiveness as a latent construct using items based on effective tax rate (ETR) for a sample of French publicly listed firms and found that greater the activity in the social dimension of CSR, the lower the level of corporate tax aggressiveness will be, whereas high activity in the economic dimension is associated with a high level of tax aggressiveness. Whait et al (2018) revealed in their analysis that there is a lack of general agreement over the definition of tax aggressiveness and CSR and not all dimensions of CSR have been addressed. Lanis and Richardson (2014) used logit regression to demonstrate that higher the level of CSR performance, lower the likelihood of tax avoidance in line with Hanlon and Heitzman (2010). Bird and Davis-Nozemack (2018) suggested that tax avoidance should be framed as a global sustainability problem as it effectively erodes common social and environmental resources.

Table 4 *Tax Avoidance: Variables, Issues, Relationship & Evidence*

Variables	Issues	Relationship	Evidence	Reference
GAAP effective tax rate, Cash effective tax rate, Tax fee rate	The effect of corporate governance, community & diversity on tax avoidance in firms that use auditor provided tax services	Tax management fees= Positive Effect on GAAP & Cash ETR= Negative	CSR effects tax avoidance when the firms are divided into portfolios on the basis of CSR levels	Huseynov&Klamm (2012) Laguir, Staglianò&Elbaz, (2015)
Offshore finance centre's or Tax havens	Companies locationand socially responsible	Positive relation	Fall short of expectations	Preusse (2010)
Tax dispute	CSR and corporate tax avoidance	Negative relation	CSR that reduces tax avoidance	Lanis and Richardson (2014)

6. Conclusion and Research Gaps

The literature review of the studies on financial implications of CSR suggest that there are more variables used in financial reporting and earnings management and very few variables used in capital structure and tax avoidance relation with CSR (Figure 1).The literature on financial reporting and CSR shows evidence that there is more disclosure by companies having high leverage, mandatory CSR mitigates information asymmetry and there has been an evolution to market based reporting. Studies on earnings management and CSR supports legitimacy theory, differentiation strategy, unbiased forecast and no relation with family involvement in ownership. Our literature also gives evidence that firms benefit from environment risk management as they shift from equity to debt and have tax benefits and CSR reduces tax avoidance but fall short of expectations to developed countries like US.

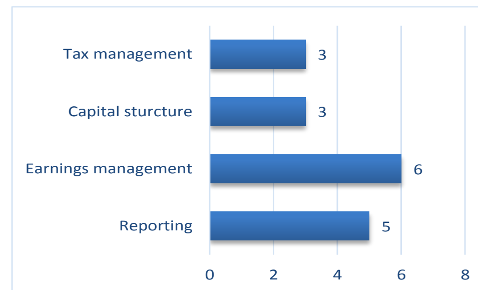

Figure 1 *Variables used in Literature Review*

Despite the rich literature on an increasing number of subjects related to CSR, there are still many questions that have not received attention. Studies measuring financial risk for CSR are yet to be investigated since environmental risk measures impact on financial risk is rarely quantifiable. The examination of environmental risk using Value at Risk (VaR) models is a step in the right direction. CSR is associated with risk management in which the objective is to avoid potential threats. The role of activist shareholders in influencing how a company reports its CSR needs to be investigated. Empirical analysis on CSR reporting practices and quality of disclosure can employ a larger sample and consider material information for stakeholders. Research surveys on CSR and financial reporting and earnings quality can bring out the practical application of CSR towards economic growth.

Another interesting avenue of research will be the CSR and its financial implication for financial besides non-financial sector. Apart from few researchers like Chih et al. (2010), Wu and Shen (2013), the examination is inadequate because of the complex nature of the financial industry. A major question which could be addressed is whether the financial industry is rewarded for taking social responsibilities.

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