A cross-country investigation into the credibility of CSR disclosures

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Abstract

Proactive strategies in the area of corporate social responsibility are becoming a "business imperative" (Kanter 2011). However, the quality of companies' disclosures about corporate social responsibility (CSR) activities remains unknown. They may be informative or they may be opportunistic and provide little useful information. We examine this issue by investigating the association between abnormal (i.e., unexpected) CSR disclosures and future firm performance using an international sample of firms drawn from 22 countries. If these disclosures are informative and if CSR activities are value-adding as Kanter (2011) suggests, there should be a positive relation between corporate social responsibility disclosures and future firm performance. Our results indicate that the two are unrelated which suggests that, on average, these disclosures are uninformative. We conjecture that since CSR activities are unobservable and since the payoffs from such activities may not be realized immediately, firms with poor CSR records may be able to mimic the high quality disclosures of good CSR performers, reducing the value of CSR disclosures.

INTRODUCTION

"Great companies work to make money, of course, but in their choices of how to do so, they think about building enduring institutions. They invest in the future while being aware of the need to build people and society."

– Rosabeth Moss Kanter (2011)

Viewed through the lens of social or institutional logic, companies have goals that affect society and their employees rather than just their shareholders. However, as Kanter's (2011) article suggests, taking such a view allows companies to build "enduring institutions" that are both admired and financially successful. Moreover, she argues that aligning the firm's objectives with social values is now a "business imperative" for companies around the globe.

Accounting researchers have long been interested in how companies disclose information about their corporate social responsibility (CSR) initiatives (e.g., see Ingram and Frazier (1980) and Wiseman (1982) for early evidence). For this line of research, the evergreen question is: Do CSR disclosures reflect firms' actual CSR performance? After 30 years of research, an answer remains elusive. Specifically, prior studies find that CSR disclosures and CSR performance may be positively, negatively, or not related (e.g., Wiseman 1982, Patten 2002, Clarkson, Li, Richardson, and Vasvari 2008). Yet this issue is important because it speaks to the credibility of these disclosures and, more fundamentally, relates to information versus opportunistic perspectives of managers' behavior.

Several possible reasons explain the mixed findings in prior studies. First, CSR performance is unobservable and difficult to measure. This suggests the signal-to-noise ratio for prior proxies of CSR performance is low, leading to low power tests. Second, most studies rely on data from a single country and, in many cases, a few selected industries, leading to fairly small samples with limited heterogeneity. Third, prior studies focus on total CSR disclosures rather than parsing out the discretionary or abnormal piece of those

disclosures. Fourth, many studies rely on self-constructed disclosure indices that have not been validated and that are difficult to compare across studies.

In this study, we provide a refined test of the relation between CSR disclosure and CSR performance. We extend and improve on prior research in the following ways. First, we acknowledge that CSR performance cannot be measured directly. Instead, we examine the relation between CSR disclosure and future firm performance. These tests are in the spirit of Tucker and Zarowin (2006) who differentiate between the information and garbling (i.e., opportunistic) views of income smoothing by examining the relation between current income smoothing and future firm performance. In our context, in line with Kanter's (2011) institutional logic, real investments in society- or employee-focused initiatives help build enduring institutions that are financially strong. If CSR disclosures provide information about these investments, CSR disclosures should be related to future profitability. If CSR disclosures are fluff, they will be unrelated.

Second, we use a sample of 690 firms from 22 countries. As Lang and Maffett (2011a) suggest, using international data affords many benefits. For example, the cross-sectional variation in both CSR disclosure and CSR performance will be greater. Also, using multiple countries allows us to consider how country-level institutions affect CSR disclosures decisions. In this way, we contribute to the line of research on cross-country accounting differences, e.g., Ball, Kothari, Robin (2000), Ball, Kothari, and Wu (2003), Francis, Khurana, and Pereira (2005), Bushman and Piotroski (2006), and Lang and Maffett (2011b).

Third, we estimate the discretionary or abnormal piece of CSR disclosures. While it is true that CSR disclosures are not mandated by accounting standards, industry norms and investor demand may lead investors to expect that firms will provide some non-zero level of CSR disclosure. Thus, analogous to abnormal stock returns or discretionary accruals, the deviation between total and expected CSR disclosure would be a better measure of the

unanticipated part of CSR disclosure. We adopt a two-stage approach in which we first model the expected level of CSR disclosure. We use a model developed by Clarkson et al. (2008) and adapt it to fit our international setting. We use the difference between actual and expected CSR disclosure as a measure of abnormal CSR disclosure. In the second stage, we examine the relation between abnormal CSR disclosure and the firm's one-year ahead ROA and stock returns.

Fourth, rather than rely on a self-constructed disclosure index, we obtain proprietary data from KPMG that rates the top 100 firms in 22 countries based on their CSR disclosures. The KPMG rating is based on responses to a questionnaire involving 52 questions (many with subcomponents) that cover the following areas: environmental strategy, stakeholder engagement, corporate management systems, reporting, climate change, supply chain, responsible investment, and assurance (KPMG 2008). The KPMG ratings are attractive because they cover a broad spectrum of CSR areas (rather than just focusing on environmental performance) and because KPMG achieved widespread participation across countries. Further, the 2008 ratings we use were the fifth set of comprehensive ratings produced by KPMG (the first was in 1993), suggesting some stability in their evaluation process. One drawback of the KPMG data is they focus on the largest firms in each country. However, since these firms are likely to the most active in the CSR area – i.e., the "enduring institutions" in Kanter's (2011) lingo – they provide a more interesting and powerful setting for testing these relations.

Overall, our results show no relation between CSR disclosures and future firm performance. These results support the opportunistic view of CSR reporting, suggesting that currently CSR disclosures are more PR than substance. In other words, like other marketing activities, firms create an image for themselves, i.e., as CSR leaders. However, our results should not be seen as evidence that CSR investments are not value-adding. They may well

be as Kanter (2011) suggests. Rather, it appears that the problem is that poor CSR performers can mimic the disclosures of CSR since talk is cheap. Thus, investors and others who wish to identify good CSR performers need to look beyond firm-provided CSR disclosures.

The remainder of this study is divided as follows. The second section covers background and theory. The third section describes the sample and method. The fourth section provides results. The fifth section concludes.

BACKGROUND AND THEORY

CSR Studies

We are interested in voluntary CSR disclosure. Therefore, we review the voluntary disclosure literature briefly to motivate our expectation for a relationship between CSR disclosure and economic performance.

Since disclosures are potentially costly (e.g., Verrecchia, 1983), managers will have specific motivations for making voluntary disclosures. Voluntary disclosure can reduce information asymmetry and adverse selection costs (e.g., Healy and Palepu, 2001). Voluntary disclosure can also increase investor awareness, leading to a larger investor base (e.g., Merton 1987). Further, additional disclosure can reduce estimation risk in that investors will be better able to estimate the parameters of firm's underlying cash flows, e.g., firm's cash flow beta (e.g., Lang and Maffett 2011a).

At the same time, managers may have incentives to act opportunistically. Verrecchia (1990) indicates that research in this area typically deals with the relation between the manager's incentives to disclose and whether the information is 'good news' or 'bad news'. For example, Healy and Palepu (2001) identify bad performance as a reason for CEOs to use voluntary disclosures to explain away the bad performance. Dedman, Lin, Prakashb, and

Chang (2008) find that there are significantly more 'good news' voluntary announcements than 'bad news' announcements, suggesting an asymmetric or biased approach by managers in deciding what information to disclose. Merkl-Davies and Brennan (2007) refer to biased reporting, i.e., where managers exploit information asymmetries between them and firm outsiders through engaging in biased reporting, as "impression management". In our context, we refer to disclosure that provides useful information to investors as 'informative' and disclosures that lack substance as 'opportunistic'.

Theories about voluntary disclosure do not specifically relate to CSR disclosures, and most studies in the literature have focused on other voluntary disclosures. Still, the relationship between CSR disclosure and CSR performance has been the focus of a number of studies. For example, Ingram and Frazier (1980) examine the relation between environmental disclosures and environmental performance. They use a self-constructed disclosure index to rate environmental disclosures and they use ratings by the Council on Economic Priorities (CEP) to measure environmental performance. Using a sample of 40 US firms, they find no relation between environmental disclosures and environmental performance, concluding that the non-relation is due to poor quality disclosures. Similarly, Wiseman (1982) and Freedman and Wasley (1990) also find no relation.

Bewley and Li (2000) focus on a sample of 188 Canadian manufacturing firms. They use Wiseman's (1982) index to score firms' environmental disclosures. They utilize two measures of environmental performance – i.e., industry membership and whether the firm participates in the Canadian government's National Inventory Pollution Release Inventory program. The find evidence of a negative relation between environmental disclosures and environmental performance, indicating poor performers are more likely to provide disclosures. Hughes, Anderson, and Golden (2001) use a sample of 51 US manufacturers and find results that are consistent with Bewley and Li (2000).

Patten (2002) attempts to overcome some of the design flaws in previous research. Rather than using subjective ratings of environmental performance from external agencies (which he argues are too limited and inconsistent across industries), he uses Toxic Release Inventory (TRI) data for 131 US firms in 24 industries. Patten (2002) also finds a negative relation between environmental disclosures and environmental performance, but the TRI data captures only one type of environmental performance and it is not clear that it is an equally valid measure of environmental performance across industries.

Al-Tuwaijri, Christensen, and Hughes (2004) also examine the relation between environmental performance and environmental disclosure. Their study differs as they also consider contemporaneous economic performance, but their disclosure index is quite limited and largely non-discretionary (e.g., Clarkson et al. 2008). Al-Tuwaijri et al. (2004) use a simultaneous equations approach and find that good environmental performers disclose more environmental information, in the form of more quantifiable environmental disclosures of specific pollution measures and occurrences, than poor performers. They attribute the prior literature's mixed results to the fact that previous research has not considered that these functions could be jointly determined and could therefore be endogenous.

Clarkson et al. (2008) develop a more comprehensive disclosure index, based on the Global Reporting Initiative sustainability reporting guidelines, and use TRI data although they industry-adjust their measures to reflect relative environmental performance in an industry. They find evidence of a positive relation between environmental disclosures and environmental performance, but like most other studies in the area, their sample is limited to just five industries which reduces the study's external validity. Finally, Clarkson, Overall, and Chappele (2011) conduct a similar study using Australian data. In contrast to Clarkson et al. (2008), they find a negative relation between environmental disclosures and environmental performance.

While Al-Tuwairjri et al. (2004) consider CSR disclosures, CSR performance, and contemporaneous economic performance, another line of research examines the relation between CSR disclosures and contemporaneous economic performance. This line of research addresses the question of whether firms that are performing well are more likely to provide CSR disclosures. Since we are interested in the relation between CSR disclosures and *future* firm performance, we only briefly review this literature.

Freedman and Jaggi (1988) examine the association between the extent of pollution disclosures and current economic performance of firms in four highly polluting industries. They used a disclosure index to measure the extent of disclosure and determined economic performance using return on assets and return on equity. The results do not indicate a significant association between contemporaneous economic performance and pollution disclosures for the total sample; however, when they segment the sample by industry and size, they do observe some negative associations.

Cormier and Gordon (2001) also find a significant negative relation between social social disclosures and economic performance. Likewise, De Villiers and Van Staden (2011) find that economic performance in the form of ROA was negatively related to environmental disclosure in the annual report, indicating that firms with bad economic performance make more disclosures. Finally, Roberts (1992) found a positive relationship between earnings and social disclosures, and Clarkson, Li, Richardson, and Vasvari (2011) find that firms with good financial performance and resources are subsequently more likely to implement proactive environmental strategies.

Recently, researchers have tried to look beyond the environmental aspect by focusing on standalone CSR reports that are issued by some companies. Two important studies are mentioned here. First, Dhaliwal, Li, Tsang, and Li (2011) explore the effect of voluntary CSR disclosure on a firm's cost of capital. They find that firms with a high cost of capital in

one year tend to initiate the disclosure of CSR activities in the next year (i.e., the first time a standalone CSR report is published) and that initiating firms with superior CSR performance enjoy a subsequent reduction in the cost of equity capital. However, Dhaliwal et al. (2011) use a binary indicator to capture the presence or non-presence of a standalone report; thus, they do not actually consider the content of those reports. We extend Dhaliwal et al. (2011) by focusing on the quality of the CSR disclosures and by using a different dependent variable, i.e., future firm performance. We focus on future firm performance because we are interested in the implications of current CSR initiatives on future realized (as opposed to expected) performance.

Second, Simnett, Vanstraelen, and Chua (2009) examine the characteristics of firms that issue sustainability reports and voluntarily have them assured. Their study is similar to ours in that they use an international sample drawn from 31 countries. They find that firms that have a greater need to enhance credibility of their reports seek assurance. Specifically, firms with a larger "social footprint" such as mining, utility, and finance firms are more likely to have their reports assured. They also find that firms in stakeholder-oriented countries (e.g., code law countries) are more likely to have their reports assured than firms in shareholder-oriented countries (e.g., common law countries). However, Simnett et al. (2009) do not examine whether firms with more "credible" sustainability reports perform better in the future. Like Dhaliwal et al. (2011), they do not explicitly consider the content of the sustainability reports.

Given the inconclusive nature of the prior literature, in this study, we provide a refined test of the relation between CSR disclosures and CSR performance. We extend the prior literature in four ways: 1) Since proxies of CSR performance are inherently noisy, we adopt the approach of Tucker and Zarowin (2006) and examine whether CSR disclosures are related to future firm performance. 2) Following Lang and Maffett (2011a), we use cross-

country data. Also, in contrast to prior studies that limit their samples to four or five industries, we include firms from a broad spectrum which recognizes that all firms have social responsibilities. 3) Analogous to discretionary accruals and abnormal stock returns, we focus on the abnormal piece of CSR disclosure since investors have expectations about the level and quality of CSR disclosure that they would normally see. 4) We use CSR disclosure ratings prepared by an external organization, i.e., KPMG, rather than relying on a self-constructed disclosure index.

International Studies

Countries differ in the way in which legal systems have been created and developed, and the way in which laws are enforced. Legal systems reflect past colonization or outright conquest and in general terms reflect their English or French-German-Scandinavian origin. As a result, capital markets can differ (in their depth and breadth), shareholder ownership patterns can differ, banking relationships can differ, and accounting reporting can differ between countries depending on the origin of their legal system.

Early research (e.g., La Porta, Lopez-de-Silanes, Shleifer, and Vishny 1997, 1998) focuses on the simple dichotomy between 'common law' and 'code' (or 'code') law countries. Common law is based on precedents established by judges in resolving actual disputes. Code law uses statutes and codes that are determined by scholars and officials. Later research has attempted to identify specific aspects of these legal systems that may be important in explaining cross-country differences in economic development. For example, there is evidence that investor protection is stronger in common law countries, and this can explain why share markets are broader and deeper in common law countries, why equity (debt) financing is more prevalent in common (code) law countries, and why ownership is more concentrated in code law countries (e.g., La Porta et al. 1997, 1998).

Given a higher dispersion of ownership in common law countries, agency problems between owners and managers are more likely to crop up in common law countries. This creates a demand for timely and transparent financial reports so that owners can monitor the managers' performance (e.g., Ball et al. 2000). On the other hand, in code law countries, information asymmetry will be less of an issue because equity markets are relatively smaller and ownership is more concentrated. In fact, in code law countries, opaqueness can even benefit the owners by allowing them to protect their private control benefits and to seek political rents (e.g., Ball et al. 2003, Fan and Wong 2005). Together, this suggests that managers face more pressure to provide more informative and credible CSR disclosures in countries with high investor protection. Simnett et al. (2011) find firms are more likely to have their sustainability reports assured and have them assured in countries with a stakeholder orientation. Since the latter corresponds with code law countries, their findings are consistent with the notion that, absent assurance, the credibility of CSR disclosures is low when investor protection is low.

As a consequence of this literature, we first consider how country-level factors affect the quality of CSR disclosures. Next, we control for investor protection or alternative country-level factors when estimating expected CSR disclosures as described below.

METHOD AND DATA

Sample

Our original sample is based on 2,171 firms from 22 different countries that were surveyed by KPMG in 2008 for the quality of CSR disclosure. KPMG considered all relevant information from 2007-2008 in developing their CSR disclosure score for each firm covered in the survey. We then delete 1,386 firms without Compustat coverage. While this represents more than half the sample, the large number arises because the KMPG sample

includes public and private firms. Next, we delete 95 firms that had insufficient data on Compustat. This results in a final sample of 690 firm observations for our main tests. As discussed later, to align the measurement of control variables with the approach employed by KPMG in constructing their CSR disclosure scores, our independent variables are also constructed after considering information from 2007 to 2008. As such, our sample consists of only one observation per firm and not multiple observations for each firm.

Research Design

Since prior studies of CSR disclosure focus on just one country, we first consider how country-level institutional factors affect the quality of CSR disclosures. We do so to determine whether it is important to include these country-level variables in our model of expected CSR disclosures that is used to compute the abnormal CSR disclosures for our main tests.

Specifically, we adapt Clarkson et al.'s (2008) model as follows:

$$\textit{CSR Disclosure} = \alpha_0 + \alpha_1 \textit{Country Institutional Variables} + \alpha_2 \textit{Size} + \alpha_3 \textit{ROA} + \alpha_4 \textit{Finance} + \alpha_5 \textit{Leverage} + \alpha_6 \textit{New Assets} + \alpha_7 \textit{CAPEX} + \alpha_8 \textit{Industry} + \alpha_9 \textit{Country} + \varepsilon \quad (1)$$

We construct our CSR disclosure measure using proprietary data collected by KPMG in 2008, following their survey of CSR reporting in firms across different countries. Specifically, KPMG based their survey on a questionnaire with 52 questions (many with sub-parts) that was completed by KPMG staff in each of the countries included in the survey for the top 100 firms in each country. The survey questions focused on measuring the extent of disclosure provided by firms in areas relating to overall environmental strategy, stakeholder engagement, corporate management systems, reporting, climate change, supply chain, responsible investment and assurance (KPMG 2008). The questions in the survey each require a 'yes' or 'no' answer, where yes (no) responses reflected the presence (absence) of

disclosures relating to a particular area of CSR performance. Each of the yes (no) responses were coded 1 (0) and then summed for each firm to derive the composite CSR disclosure score (*CSR Disclosure*).

We employ eight different proxies to capture the level of investor protection and societal concerns across the countries represented in our sample. Panel A of Table 1 defines the country-level measures in detail and states their expected relationship with *CSR Disclosure*.

<<< INSERT TABLE 1 ABOUT HERE >>>

Our first four measures are extracted from the World Bank website (http://info.worldbank.org/governance/wgi/mc_countries.asp) and capture (1) the extent to which agents have confidence in and abide by the rules of the society (*Rule of Law*), (2) the extent to which a country's citizens are able to select their government and voice other concerns (*Voice and Acctblty*), (3) perceptions of the quality of public services and polices, and the government's commitment to such policies (*Govt Effectiveness*), and (4) perceptions of the government's ability to formulate and implement sound policies (*Reg Quality*). All four measures are allocated values ranging between -2.5 to 2.5, where higher values reflect a stronger enforcement environment (*Rule of Law*), higher participation in government selection (*Voice and Acctblty*), more effective governments (*Govt Effectiveness*), and higher regulatory quality (*Reg Quality*). Based on previous literature which documents a positive relation between strong government institutions and accounting quality (e.g., Bushman and Piotroski 2006), we expect all four measures to be positively related to CSR disclosure.

Our next three measures capture societal concerns about CSR issues. The first of these is derived from AccountAbility, a global organisation that sets standards for corporate responsibility and sustainable development (www.accountAbility.org). This organization provides a country-level responsibility index measure that describes the comparative

performance of countries in providing an enabling environment for responsible business practices in the future (*Respsblty Index*). Higher values for this index reflect more accountable countries. Thus, we predict a positive relationship between *Respsblty Index* and *CSR Disclosure.*

The next measure of societal concerns is constructed using data provided by Yale Law School (http://epi.yale.edu/). The Yale Center for Environmental Law and Policy and the Center for International Earth Science Information Network at Columbia University have developed national-scale environmental indices since 1998, producing an environmental performance index for more than 150 countries (*Envrnmtl Perfmnce*) that is released every two years. The values for *Envrnmtl Perfmnce* can range between 0 to 100 with higher values indicating countries that strongly pursue environmental policy goals. A such, we expect *Envrnmtl Perfmnce* to be positively related to *CSR Disclosure*.

Our third measure of societal concerns is derived from the Reporters Without Borders website (http://en.rsf.org/) and reflects the degree of freedom journalists and media have in more than 170 countries. The values for this measure can range from 0 to 100 with lower values reflecting higher freedom of press. To align the interpretation of this measure with that of the above-mentioned investor protection measures, we multiply this measure by -1 before including it in our analysis (*Press Freedom*) so that higher values indicate higher freedom of press. Our prior expectation is that there is a positive relationship between *Press Freedom* and *CSR Disclosure.*

Finally, we also consider a country's legal origin (*Legal Origin*). As discussed above, legal origin is a more primitive measure of country-level differences that captures a broad range of country-level characteristics. La Porta et al. (1998) show that countries with a common law legal origin provide more disclosures. Ball et al. (2000) show that accounting income of firms in common law countries reflects economic income in a more timely

manner, in comparison to the accounting income of firms in code law countries. These findings are attributed by the fact that common law develops from a focus on meeting the demands of contracting in markets and stresses legal procedure over rules. *Legal Origin* is coded 1 if the country has a common law tradition, and 0 otherwise (if the country has a code law tradition). In line with prior studies that have documented higher levels of corporate disclosure in common law countries (La Porta et al. 1998 and Ball et al. 2000), we expect a higher level of CSR disclosure in common law countries.

Following prior research (Clarkson et al. 2008), we control for several other determinants of CSR disclosure. Panel B of Table 1 lists the variables controlled for in our study, together with a description of how the variables are measured, and the variables expected relationship with *CSR Disclosure*. To begin, we control for firm size (*Size*) because larger firms are expected to disclose more information due to economies of scale with respect to information production costs (e.g., Clarkson et al. 2008). We also control for firm performance (*ROA*) because firms with superior performance are likely to disclose more information (e.g., Lang and Lundholm 1993). The amount of debt and equity financing raised (*Finance*) is also included in our analysis because firms that readily access debt and equity markets have a higher propensity for disclosures (e.g., Frankel, McNichols, and Wilson 1995).

Next, we control for total debt (*Leverage*) because highly levered firms are expected to disclose more information due to a higher demand for information by debtholders (e.g., Leftwich, Watts, and Zimmerman 1981). Firms with newer assets are likely to have cleaner technologies that should motivate them to disclose more about their investments in environmental technologies. Accordingly, we control for the extent to which a firm's portfolio of equipment is composed of new assets (*New Assets*). Finally, capital expenditure (*CAPEX*) is also controlled for because firms that spend more resources to acquire newer

equipment are more likely to acquire cleaner technologies and disclose more information about their investments to their stake holders. We also include industry and country dummies (*Industry* and *Country*) to control for industry- and country-level effects on CSR disclosure.

To test our main hypothesis, we employ a two-stage approach. In stage 1, we estimate abnormal CSR disclosure by modelling the expected piece of CSR disclosure using eq. (1). However, since all the country-level variables are correlated to some degree, we use factor analysis to extract the common element(s) across these variables, and we estimate eq. (2):

$$\textit{CSR Disclosure} = \alpha_0 + \alpha_1 \textit{Country Institutional Factor(s)} + \alpha_2 \textit{Size} + \alpha_3 \textit{ROA} + \alpha_4 \textit{Finance} + \alpha_5 \textit{Leverage} + \alpha_6 \textit{New Assets} + \alpha_7 \textit{CAPEX} + \alpha_8 \textit{Industry} + \alpha_9 \textit{Country} + \varepsilon \quad (2)$$

In stage 2, in the spirit of Tucker and Zarowin (2006), we examine the relation between excess CSR disclosure and subsequent accounting operating performance by adapting Core, Holthausen, and Larcker's (1999) model as follow:

$$\textit{ROA} = \beta_0 + \beta_1 \textit{AbCSR Disclosure} + \beta_2 \textit{STD ROA} + \beta_3 \textit{Sales} + \beta_4 \textit{Industry} + \beta_5 \textit{Country} + \varepsilon \quad (3)$$

where *ROA* is the return on assets in the 2009 fiscal year, *STDROA* is the standard deviation of return on assets over the period 2004 to 2008, *Sales* is total sales in the 2009 fiscal year, and all of the other variables are as previously defined.

We employ the following regression analysis to examine the relationship between excess CSR disclosure and subsequent stock market performance:

$$\textit{Return} = \gamma_0 + \gamma_1 \textit{AbCSR Disclosure} + \gamma_2 \textit{STD Return} + \gamma_3 \textit{Mkt Cap} + \gamma_4 \textit{Growth} + \gamma_5 \textit{Industry} + \gamma_6 \textit{Country} + \varepsilon \quad (4)$$

where *Return* is the stock return in the 2009 fiscal year, *STD Return* is the standard deviation of stock return over the period 2004 to 2008, *Mkt Cap* is the market capitalization at the end of the 2009 fiscal year, and *Growth* is the market-to-book ratio at the end of the 2009 fiscal year.

FINDINGS

Preliminary Analyses

Panel A of Table 2 reports descriptive statistics on the dependent variable (*CSR Disclosure*), which is constructed by summing up the coded responses to the 52 questions included in the KPMG survey, where a response was were coded 1 (0) if it reflected the presence (absence) of disclosure relating to a particular area of CSR performance covered by a survey question. The mean (median) value of *CSR Disclosure* in our sample is 24.384 (23.000) indicating that many firms in our sample provide disclosures on less than half of the 52 areas of CSR performance covered by the KPMG survey.

<<< INSERT TABLE 2 ABOUT HERE >>>

Descriptive statistics on the country-level attributes used to construct our test variables are reported in Panel B of Table 2. Moreover, panel B also reports summary statistics for sample firms with a *CSR Disclosure* value lower than the sample median (Low Discl. Sample) and higher than the sample median (High Discl. Sample). Results from tests of differences based on these two sub-samples suggest that firms in the higher disclosure sample appear to operate in countries that have: a stronger enforcement environment (*Rule of Law*), higher participation in government selection (*Voice and Acctblty*), more effective governments (*Govt Effectiveness*), higher regulatory quality (*Reg Quality*), more accountability (*Respsblty Index*), stronger environmental agenda (*Envrnmtl Perfmnce*), and higher press freedom (*Press Freedom*). These findings are significant at the 10 percent level or better and are consistent with our expectations.

Panel C of Table 2 reports the summary statistics for the control variables. We find that firms with higher-levels of CSR disclosures are larger in size ($p < 0.01$), more profitable ($p < 0.05$), more highly levered ($p < 0.10$), and have older assets than firms with low-levels of CSR disclosures.

Table 3 reports Pearson and Spearman correlation matrices. Pearson correlation statistics indicate that *CSR Disclosure* is positively correlated with *Rule of Law, Voice and Acctblty, Reg Quality, Respsblty Index, Envronmtl Perfmnce*, and *Press Freedom*. Overall, our first six country-level measures of investor protection are positively correlated with each other, with the correlation coefficients ranging from 0.072 to 0.963. In contrast, these measures are negatively correlated with our last two country-level measures of investor protection (*Legal Origin* and *Press Freedom*). Because there are a number of significant correlations between the country-level measures, in subsequent analyses, we either analyze the measures independently or collapse them into a few orthogonal factors.

<<< INSERT TABLE 3 ABOUT HERE >>>

Table 4 reports the results for eq. (1), which regresses the extent of CSR disclosure in our sample firms (*CSR Disclosure*) on the individual country-level investor protection measures and the control variables. Recall that we employ eight different measures of country-level investor protection in our study. The regression results based on each of the country-level investor protection measures are reported in columns three through to ten of Table 4, respectively.

<<< INSERT TABLE 4 ABOUT HERE >>>

The results for the first seven country-level investor protection measures are all consistent with our expectations, i.e., their associations with *CSR Disclosure* are positive and significant ($p < 0.01$). This indicates that higher levels of CSR disclosure in countries that have: a stronger enforcement environment (*Rule of Law*), higher participation in government selection (*Voice and Acctblty*), more effective governments (*Govt Effectiveness*), higher regulatory quality (*Reg Quality*), more accountability (*Respsblty Index*), stronger environmental agenda (*Envrnmtl Perfmnce*), and higher press freedom (*Press Freedom*). On the other hand, we find that *Legal Origin* is negatively and significantly ($p < 0.01$) associated

with *CSR Disclosure*. This is contrary to our expectations as it suggests the CSR disclosures are of higher quality in code law countries. Simnett et al.'s (2009) results provide a possible explanation. They find firms in stakeholder countries – which closely corresponds to code law countries – are more likely to have their sustainability reports assured because they have to, i.e., otherwise investors would discount these statements. By the same token, firms in our code law countries may feel compelled to improve the extent and quality of their CSR disclosures.

The results for the control variables indicate that firm size (*Size*) is positively associated with *CSR Disclosure* ($p < 0.01$) across all regression analyses reported in Table 4. The adjusted R^2 of regression analyses range between 37.50 percent to 39.40 percent, suggesting that our independent variables collectively capture a substantial variation in our CSR disclosure measure. The key take-away from Table 4 is that it is important to include country-level institutional factors when estimating expected CSR disclosures.

Main Results

To assess the credibility of CSR disclosures, we use a two-step process as described above. First, we estimate abnormal CSR disclosures, *AbCSR Disclosure*, by estimating eq. (2), and second, we examine the relation between *AbCSR* Disclosure and future firm performance by estimating eqs. (3) and (4).

To estimate eq. (2), we first factor analyze the eight country-level measures since they are highly related. We find that the eight variables load on two factors. We label these *Investor Protection 1* and *Investor Protection 2*, respectively. Then, we regress *CSR Disclosures* on *Investor Protection 1*, *Investor Protection 2*, and our control variables. The residual term from the estimation of eq. (2) is our proxy for the abnormal portion of CSR disclosures (*AbCSR Disclosure*). The adjusted R^2 of eq. (2) is 39.1 percent which suggests

we are capturing a substantial amount of the variation in CSR disclosures. By comparison, our 39.1 percent is better than the mean of 23.2 percent reported by Jones (1991, Table 4) who models the non-discretionary portion of accruals and is comparable to the 37.2 percent reported by Core et al. (1999, Table 2) who model predicted CEO compensation. Those studies use their models to compute discretionary accruals and excess CEO compensation, respectively. As we discuss above, investors have expectations about the amount and quality of CSR disclosures that a company will provide so it is the deviation from the expected amount that reflects the manager's discretion. This discretion can be used to provide more information or to mislead investors.

<<< INSERT TABLE 5 ABOUT HERE >>>

Table 5 provides the results from the estimation of eqs. (3) and (4). To the extent that pursuing CSR initiatives helps build enduring institutions that are financially strong (e.g., Kanter 2011), we would expect to find a positive association between *AbCSR Disclosure* and future firm performance *if CSR disclosures are credible*. In second and third columns of Table 5 which shows the results for eq. (3), the coefficient on *AbCSR Disclosure* is insignificant. Thus, the unexpected piece of CSR disclosures is not related to future ROA which provides support for the opportunistic view. Similarly, in the last two columns of Table 5, we find no evidence of a relation between *AbCSR Disclosure* and future stock returns (eq. 4). As a result, our evidence supports the opportunistic view where managers provide CSR disclosures to manage impressions.

CONCLUSION

Firms pursue CSR initiatives to address societal and employee concerns, but Kanter (2011) argues that doing so makes business sense. That is, being socially responsible leads to stronger financial performance and allows the firm to establish itself in a leading position,

i.e., an “enduring institution” in Kanter’s words. This suggests a positive relation between CSR initiatives and future firm performance.

Firms can provide information to investors, and other parties, about the CSR initiatives by providing CSR disclosures. On the other hand, firms who are not engaged in CSR initiatives could mimic the firms who are engaged by also providing – or by embellishing – CSR disclosures. Thus, one way to test the credibility of CSR disclosures is to examine the relation between those disclosures and future firm performance. If CSR disclosures accurately reflect CSR initiative, CSR disclosure and future firm performance will be positively related. If CSR disclosures are mainly fluff, CSR disclosures and future firm performance will not be related or may be negatively related.

In our study, we provide a test of the relation between CSR disclosures and future firm performance. We advance the research in three additional ways. First, we use a sample drawn from 22 countries, in contrast to prior studies that have focused only on single countries. Second, we focus on the unexpected portion or abnormal portion of CSR disclosures as this captures the part of CSR disclosures that is affected by managerial discretion. Third, rather than relying on a self-constructed disclosure index, we use ratings of CSR disclosures made by a third party. In particular, we gain access to a proprietary dataset of KPMG.

In preliminary analyses, we show that measures related to country-level institutions are related to CSR disclosures. Thus, in computing expected CSR disclosures, we combine these variables using a factor analysis, and we include them in an expectations model based on Clarkson et al. (2008). We use the residual from this model as a measure of unexpected CSR disclosure, and we regress future firm performance – measured as future ROA or future stock returns – on the unexpected CSR disclosure and control variables. We find no evidence of a relation between unexpected, or abnormal, CSR disclosure and future firm performance.

Our results do not imply that all CSR disclosures lack credibility. Rather they suggest that companies who are not performing highly in the CSR area are able to mimic companies that are good performers by providing extensive CSR disclosures – and that investors have difficulty in distinguishing between the two types of companies. One reason that unsuccessful firms can get away with such behavior is that actual CSR performance is unobservable and the benefits of the CSR investments might not be realized immediately. This also explains why investors are not able to discern between the firms that are providing CSR disclosures for informative and opportunistic reasons.

Overall, our study contributes to a line of research examining CSR disclosures and CSR performance. More than 30 years of prior research has been unable to determine whether a relation between CSR disclosures and CSR performance exists. Our findings suggest that CSR disclosures are not good measures of CSR performance. By and large, they are more fiction than fact.

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TABLE 1
Variable Definitions

Variable	Predicted Sign	Variable Measurement
Panel A: Test Variables		
Rule of Law	+	Perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence (Source: World Bank - http://info.worldbank.org/governance/wgi/mc countries.asp)
Voice and Acctblty	+	Perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media. (Source: World Bank)
Govt Effectiveness	+	Perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. (Source: World Bank)
Reg Quality	+	Perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. (Source: World Bank)
Respsblty Index	+	The state of responsible competitiveness- making sustainable development count. Represents pressure on firms to be sustainable. (Source: Account Ability - www.accountAbility.org)
Envrnmtl Perfmnce	+	Environmental performance index from the point of view of law, policy and science (Source: Yale Law School - http://epi.yale.edu/)
Legal Origin	+	1 if the if the country has a common law tradition, and 0 otherwise (if the country has a civil law tradition)
Press Freedom	+	Freedom of press measure – a free press promotes governmental accountability. (Source: Reporters without Borders - http://en.rsf.org/)
Panel B: Control Variables		
Size	+	Average natural logarithm of total assets (Compustat item AT) over the 2007 and 2008 fiscal years
ROA	+	Average income before extraordinary items (Compustat item IB) scaled by total assets over the 2007 and 2008 fiscal years
Finance	+	Average of the sum of change in debt (Compustat item DLC and DLTT) and common equity Compustat item # CEQ) scaled by total assets over the 2007 and 2008 fiscal years
Lev	+	Average debt scaled by total assets over the 2007 and 2008 fiscal years
New Assets	+	Average net property, plant and equipment (Compustat item # PPENT) scaled by gross property, plant and equipment Compustat item # PPEGT) over the 2007 and 2008 fiscal years
CAPEX	+	Average capital expenditure Compustat item # CAPX) scaled by total sales over the 2007 and 2008 fiscal years

TABLE 2
Descriptive Statistics

	Full Sample (n = 690)		Low Discl. Sample (n = 348)		High Discl. Sample (n = 342)		Test of Differences
	Mean	**Median**	**Mean**	**Median**	**Mean**	**Median**	***t*-statistic**
Panel A: Descriptive Statistics for Dependent Variable							
CSR Disclosure	24.384	23.000	10.491	10.000	38.520	37.500	42.36***
Panel B: Descriptive Statistics for Test Variables							
Rule of Law	1.284	1.610	1.181	1.610	1.388	1.380	3.90***
Voice and Acctblty	1.109	1.110	1.071	1.110	1.146	1.110	2.73***
Govt Effectiveness	1.462	1.650	1.422	1.650	1.502	1.450	1.80*
Reg Quality	1.280	1.390	1.236	1.520	1.325	1.210	2.49**
Respsblty Index	69.471	69.600	68.853	69.600	70.101	69.600	2.44**
Envrnmtl Perfmnce	83.699	84.200	82.950	82.700	84.461	84.500	3.17***
Legal Origin	0.362	0.000	0.382	0.000	0.342	0.000	-1.09
Press Freedom	-7.823	-6.500	-9.177	-7.670	-6.446	-6.500	4.39***
Panel C: Descriptive Statistics for Control Variables							
Size	9.111	9.091	8.492	8.488	9.740	9.809	11.36***
ROA	0.043	0.039	0.049	0.043	0.036	0.032	-2.03**
Finance	0.074	0.050	0.079	0.049	0.070	0.051	0.68
Lev	0.296	0.265	0.283	0.244	0.310	0.277	1.76*
New Assets	0.532	0.522	0.550	0.527	0.514	0.512	-3.07***
CAPEX	0.139	0.055	0.178	0.043	0.099	0.065	0.81

Low Discl. Sample consists of firms with CSR disclosure scores (*CSR Disclosure* values) less than the sample mean. High Discl. Sample consists of firms with CSR disclosure scores (*CSR Disclosure* values) above than the sample mean. See Table 1 for variable definitions.

TABLE 3

Correlation Matrix Spearman (Pearson) Correlations in the Upper (Lower) Diagonal[a]

		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
CSR Disclosure	(1)		0.023	0.027	-0.005	**0.080**	0.052	**0.103**	-0.037	0.043	**0.468**	**-0.080**	-0.013	**0.112**	**-0.084**	**0.263**
Rule of Law	(2)	**0.157**		**0.921**	**0.991**	**0.873**	**0.929**	**0.613**	0.055	**0.854**	-0.029	0.001	0.049	0.018	**-0.184**	**-0.125**
Voice and Acctblty	(3)	**0.121**	**0.903**		**0.904**	**0.851**	**0.899**	**0.604**	-0.001	**0.878**	**-0.095**	0.032	**0.082**	0.061	**-0.192**	**-0.091**
Govt Effectiveness	(4)	0.072	**0.963**	**0.852**		**0.868**	**0.928**	**0.583**	0.071	**0.829**	-0.043	0.020	0.038	-0.012	**-0.176**	**-0.143**
Reg Quality	(5)	**0.110**	**0.930**	**0.884**	**0.903**		**0.921**	**0.438**	**0.285**	**0.704**	0.071	0.024	0.027	0.040	**-0.129**	**-0.140**
Respsblty Index	(6)	**0.085**	**0.910**	**0.894**	**0.918**	**0.898**		**0.621**	**0.133**	**0.818**	0.000	-0.011	0.041	0.042	**-0.156**	**-0.117**
Envrnmtl Perfmnce	(7)	**0.102**	**0.622**	**0.624**	**0.557**	**0.527**	**0.595**		**-0.297**	**0.697**	**0.087**	**-0.125**	0.040	0.064	**-0.236**	-0.001
Legal Origin	(8)	0.059	**-0.079**	-0.058	**-0.114**	**-0.237**	**-0.102**	**0.427**		**-0.107**	**-0.119**	**-0.179**	0.071	**0.088**	**-0.223**	0.059
Press Freedom	(9)	**-0.193**	**-0.729**	**-0.762**	**-0.670**	**-0.575**	**-0.661**	**-0.302**	**0.100**		**0.185**	0.030	**-0.146**	-0.066	**0.236**	0.034
Size	(10)	**0.440**	**0.199**	0.028	**0.089**	**0.157**	0.022	**0.096**	**-0.123**	-0.034		**-0.171**	**-0.178**	**0.097**	**-0.100**	**0.125**
ROA	(11)	-0.045	**-0.124**	-0.042	**-0.082**	-0.074	-0.055	**-0.186**	**-0.157**	-0.005	**-0.165**		**0.285**	**-0.279**	**0.092**	**0.103**
Finance	(12)	-0.002	-0.015	0.053	-0.008	-0.006	0.025	-0.043	-0.019	-0.073	**-0.168**	**0.201**		**0.295**	**0.190**	**0.252**
Lev	(13)	**0.092**	0.031	0.065	-0.012	0.023	0.025	0.040	0.051	**-0.088**	**0.080**	**-0.220**	**0.515**		**0.153**	**0.302**
New Assets	(14)	**-0.096**	**-0.225**	**-0.206**	**-0.186**	**-0.172**	**-0.191**	**-0.230**	**-0.211**	**0.132**	**-0.111**	**0.085**	**0.238**	**0.209**		**0.247**
CAPEX	(15)	-0.044	0.032	0.046	0.032	0.003	0.031	0.058	0.028	-0.033	**-0.096**	**-0.216**	**0.098**	**0.079**	**0.133**	

[a] Correlations significant at the two-tailed 0.05 level are in bold figures.
See Table 1 for variable definitions.

TABLE 4

Regression of CSR Disclosure on Country-Level Investor Protection Measures and Controls

	Expected Sign	Coefficient t-statistic	Coefficient t-statistic	Coefficient t-statistic	Coefficient t-statistic	Coefficient t-statistic	Coefficient t-statistic	Coefficient t-statistic	Coefficient t-statistic
Intercept	?	-50.581	-70.615	-41.333	-67.966	-108.337	-96.483	-12.183	-17.677
		0.005***	0.000***	0.000***	0.000***	0.000***	0.000***	0.010***	0.000***
Rule of Law	+	17.087							
		0.007***							
Voice and Acctblty	+		33.802						
			0.000***						
Govt Effectiveness	+			11.032					
				0.010***					
Reg Quality	+				28.840				
					0.000***				
Respsblty Index	+					1.172			
						0.000***			
Envrnmtl Perfmnce	+						0.816		
							0.000***		
Press Freedom	+							2.666	
								0.000***	
Legal Origin	+								-6.916
									0.001***
Size	+	5.348	5.974	5.359	5.423	5.546	5.822	6.010	5.458
		0.000***	0.000***	0.000***	0.000***	0.000***	0.000***	0.000***	0.000***
ROA	+	1.236	1.502	1.264	2.452	1.453	1.273	1.346	0.783
		0.433	0.417	0.431	0.367	0.420	0.430	0.426	0.457
Finance	+	2.088	1.495	1.264	2.335	2.443	1.530	1.444	2.039
		0.303	0.354	0.431	0.281	0.270	0.352	0.359	0.307
Lev	+	-0.041	-0.356	0.035	-0.886	-1.109	-0.010	-0.256	0.039
		0.495	0.459	0.496	0.399	0.374	0.499	0.470	0.496
New Assets	+	-0.522	-0.010	-0.520	-3.805	-1.659	0.368	0.353	0.416
		0.449	0.499	0.450	0.174	0.339	0.464	0.465	0.460
CAPEX	+	-0.257	-0.223	-0.256	-0.190	-0.227	-0.241	-0.228	-0.270
		0.270	0.295	0.271	0.325	0.292	0.282	0.291	0.259
Industry/Country fixed effects		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted R^2		0.375***	0.394***	0.374***	0.384***	0.391***	0.387***	0.394***	0.378***

See Table 1 for variable definitions.

TABLE 5

Regression of Accounting and Stock Performance on Abnormal CSR Disclosures and Controls

	Accounting Performance (n = 555)		Stock Performance (n = 516)	
	Coefficient	***t*-statistic**	**Coefficient**	***t*-statistic**
Intercept	0.0017	0.03	-123.5040	-2.72***
AbCSR Disclosure	-0.0001	-0.27	0.0916	0.21
STD ROA	0.3352	2.90***		
Sales	0.0050	1.13		
STD Return			16.82468	73.32***
Mkt Cap			12.1766	3.21***
Growth			-0.01879	-0.58
Industry fixed effects	Yes		Yes	
Country fixed effects	Yes		Yes	
Adjusted R^2	0.0691		0.9178	

The second and third (last two) columns present the results from regression of one year ahead accounting and stock performance on abnormal CSR disclosures and controls. *AbCSR Disclosure* is estimated as the residual term from the estimation of eq. (2). Since all the country-level variables are correlated to some degree, we use factor analysis to extract the common element(s) across the country level variables employed in eq. (1) and use the resulting two factors as explanatory variables in eq. (2). Accounting performance is the return on assets in the 2009 fiscal year (*ROA*); *STDROA* is the standard deviation of return on assets over the period 2004 to 2008; *Sales* is total sales in the 2009 fiscal year; stock performance is the stock return in the 2009 fiscal year (*Return*); *STD Return* is the standard deviation of stock return over the period 2004 to 2008; *Mkt Cap* is the market capitalization at the end of the 2009 fiscal year; and *Growth* is the market-to-book ratio at the end of the 2009 fiscal year.