The Relationship between Earnings Quality and Corporate Social Responsibility with Emphasis on the Stability of their Performance

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ABSTRACT

This study examines the relationship between earnings quality and corporate social responsibility, with an emphasis on stability performance. In this study some variables including corporate social responsibility, firm size, the ratio of book value to market value of equity, adjusted ROA, great auditors, financial leverage and establishment duration are considered as independent variables. The four criteria of discretionary accruals, operating cash flows, discretionary operational and production costs have been chosen as the dependent variables. If the profit of a firm is lower than expected, this can reduce the price of the company considerably. High concentration of users on profit, increases its quality and accruals as an criterion of earnings quality has been considered. In addition to have the responsiveness responsibility to the owners, to legitimize their performance, economic enterprises should fulfill their social responsibility. To answer this question as there is an association between stability coefficient of performance of firms with accruals, operating cash flows and operational discretionary costs of production, of 90 companies in Tehran Stock Exchange in the period 2002 to 2011, some firms are selected and Excel &Eviews software are used for data analysis.

KEYWORD

performance stability, Discretionary accruals, Discretionary expenses, Corporate social responsibility, Earnings quality

INTRODUCTION

Today, with the development of industries and different commercial units, new problems are created as we need to present relevant information of mutual effects of business units’ performance and society for better decision making of financial statements users. Traditional accounting principles as relevance, accrual component, objectivity, conservatism, separation of personality and historical costs are not able to respond the social costs and concern for human being welfare (sikka, 2011). There is a general belief that beyond the attempt to maximize the firm profit, the organizations and companies have vital role in solving the problems of society. The basic idea of corporate social responsibility (CSR) reflects the requirements and social outcomes of success in business (Babalula, 2012). Corporate stability is a different approach to business creating long-term value for the customers and employees. In this approach, all the dimensions of a business performance, social, cultural and economic dimensions are considered beside environment (Benson, 2012). The fundamental changes in the past years in economy are unavoidable. On the other hand, the development of economic enterprises with the complexity of business trading and decision making systems required relevant and reliable information by which optimal allocation of limited resources is performed (GhanbariMoghadam, 2013). Indeed, presenting useful information and correct criterion to investors in stock market as it provides logical basis for their correct decision can maintain the continuity of the presence of investors in stock market on one hand and it also can keep their benefits and prevent their loss and these can make progress in stock market. Also, by providing a ground for optimal allocation of limited economic resources, we can achieve profitable plans and economic growth (JafarChashmi, 2013). Thus, the firms observing their social responsibility have responsible behavior to earnings quality. They have more transparent and reliable information for stockholders compared to other firms. Thus, it is expected they have stable performance and growth. CSR plays important role in restricting earnings management and such companies are more inclined to conservatism in operational and accounting decisions and are less inclined to manage aggressive income via discretionary accruals or manipulate actual activities (Kim et al., 2012).
THEORETICAL BASICS AND REVIEW OF LITERATURE

If the company profit is less than expected, this reduction can reduce stock price of a firm considerably. However, achieving higher profit than the predict value is a good news. The focus on profit is high and it seems instead of emphasis on company performance, investors are only involved in profit. Maybe it is forgotten that the report net profit is the final result of a long accounting process and it is calculated by the accounting procedures selected by management (Saghafi and Kordestani, 2004). The high focus of profit users increased considering its quality and accrual accounting is considered as an index of earnings quality. If accounting profit is higher than inflow cash flow of firm, the extra is created by accruals (Degorgie et al., 1999). Although society including people and environment forming economic enterprises is the main audience for the stockholders, there are other audiences as government, employees and other non-state institutions who can intervene. Thus, the continuance of economic enterprise activity depends upon fulfilling social responsibility beside other responsibilities. Accounting standards presenting financial reporting procedures as norm to the economic enterprise manager didn’t pay attention seriously to the responsiveness of enterprises to information needs of all mentioned audiences. Although the rights of government in financial reporting are clear, the rights of other audiences as non-state institutions and minority shareholders and others are not clear yet. According to Carol (1979), economic enterprises should observe four responsibilities to fulfill social responsibility as:

1- Economic responsibility, 2- Legal responsibility, 3- Ethical responsibility, 4- Voluntarily responsibilities (Rahimian, 2012).

The role of accruals is changing or modification of cash flow identification and adjusted prices (adjusted income) is used as a criterion for measuring company performance based on accounting concepts statement No.1. Accruals are mostly based on the assumptions and if they are not correct, the accruals and future profit can be modified. The accruals quality and profit are reduced based on their estimation error size (Qaemi, 2008). Accruals are defined as the difference between accounting profit and cash flow and cash flow is the main element considered by investors and by which the quality of accruals and accounting profit is identified. Indeed, we can define accruals quality for investors as the degree of close relation of firm profit with the created cash flows. Accruals improve profit stability to cash flows with high accruals but in the firms with low accruals, earnings stability is reduced. Thus, there is a positive (direct) relationship between discretionary accruals and stability coefficient of performance. Free cash flows are defined as investment of these cash flows in projects with net present value (NPV). It is expected that the firms with high cash flow and low growth opportunity invest more free cash flows in non-profitable projects. Although such projects lead to reduction of the shareholders wealth, the personal benefits of managers can be fulfilled. Boket et al., believes that earnings manipulation is high in the companies with high free cash flows. Thus, it is expected that free cash flow has direct association with stability coefficient of performance. Discretionary product cost including the costs of sold goods and the changes in invoice, we can compensate surcharge cost by great number of products by increasing production level. Thus, this reduces the fixed costs of each unit of goods and if it is not exchanged by the increase of final cost, the total cost of each product unit is reduced. Thus, the costs of sold goods are reduced and operational profit margin of firm is increased. Thus, managers are inclined to more productions if the reduction of production costs is higher than invoice holding costs in the period (Roychowdhury, 2006). Thus, it is expected the discretionary product cost is associated with performance stability coefficient. Administrative, public and sale costs are discretionary expenses as they include some expenses as training staffs, keeping and travel and the manager is responsible in this regard. Discretionary expenses as R&D, advertisement and maintenance expenses are considered in occurrence period. Thus, by increasing discretionary expenses, firms can reduce reported costs and increase profit. This is occurred when such expenses don’t lead to income and immediate profit achievement. If managers reduce discretionary expenses to achieve profitability goals, they are obliged to show these expenses abnormally low. The expenses of administrative advertisement, public and sale are considered as discretionary expenses (Roychowdhury, 2006). Thus, it is expected that discretionary operational cost is associated with stability coefficient of performance.

Pomering and Johnson (2009) in a study found that CSR includes some issues as human rights, labor force, employment (e.g. health and safety of employees), unfired commercial measurements, organizational governance, environmental aspects, market and consumer issues, society participation and social development.

Benson et al., (2011) found that there was a positive and significant association between CSR and earnings management. The consistency between CSR and financial reporting was an empirical behavior. The companies observing “social responsibility” present better earnings management.

Kim et al., (2012) investigated whether earnings quality is associated with CSR or not? and found that CSR firms are less inclined to be involved in aggressive income management via discretionary accruals or manipulation of actual activities and they play important role in limiting earnings management. These firms are more inclined to conservatism in operational and accounting decision and present transparent financial information to investors. Rezayi and Babayi (2013) in a study analyzed the effective factors on performance stability coefficient of firms by data envelope analysis and also they evaluated the impact of size, financial leverage, free cash flow, profitability and growth opportunities. The empirical evidences of hypotheses test showed that there was a negative and significant association between firm size and financial leverage with performance stability coefficient in Iran capital market. Based on the results, there was a positive association between free cash flows, profitability and growth opportunities of firms with performance stability coefficient. Naseri et al., (2012) investigated the relationship between social performance...
and financial performance. They stated that stakeholders’ behavior is a part of linking mechanism of social performance and financial performance and it is based on the hypothesis that for the influence of social responsibility behavior on financial performance of firm, stakeholders are aware of company behavior and they are inclined to influence the company. Indeed, there was a positive association between financial performance and social performance. HasasYegane et al., (2012) states that accepting performance stability in long-run improves financial performance of business unit, increasing competitive advantage and long-run success of business unit. TO achieve these goals, the firms should show the stakeholders to attempt with stability go al to fulfill their expectations.

**STUDY METHODOLOGY**

The present study is empirical and ex post facto, based on actual and previous information. It is descriptive-correlation in terms of data collection. The main purpose of the study is determining the existence, amount and type of relation among the study variables. This study is applied in terms of purpose. To test the study hypotheses, the classified and audited financial data of the manufacturing firms listed on TSE are used. The study population is all the non-financial firms listed on TSE during 2002 to the end of 2011. The study population is screening and is selected by the following criteria:

1- The type of activity of firm is manufacturing and financial institutions, investment, banks, insurance, Leasing and Holding companies are ignored.
2- The firms with maximum six months of trading stopping.
3- The fiscal year ends to the end of Esfand and the financial period of firms is not changed.
4- Their financial information is available from the beginning of fiscal year 2002 to the end of fiscal year 2011 (time period)
5- The book value of their equity is not negative as to achieve growth, the book value of equity should be positive.

This study investigates the relationship between earnings quality and CSR with emphasis on their performance stability and the financial information of the firms listed on TSE during 2002 to 2011 is investigated. Based on the sum of above conditions, 90 companies are selected during the study period. Study hypotheses First hypothesis: There is a positive association between performance stability coefficient of the firms and discretionary accruals. Second hypothesis: There is a negative association between performance stability coefficient of the firms and discretionary accruals. Third hypothesis: There is an association between performance stability coefficient of the firms and absolute value of discretionary accruals. Fourth hypothesis: There is an association between performance stability coefficient of the firms and discretionary operational cash flows. Fifth hypothesis: There is an association between performance stability coefficient of the firms and discretionary production costs. Sixth hypothesis: There is an association between performance stability coefficient of the firms and discretionary operational costs.

**DESCRIPTIVE ANALYSIS OF STUDY VARIABLES**

For data analysis, at first the descriptive statistics is calculated. In this section, descriptive statistics include mean maximum and minimum, standard deviation, observations of each of independent, dependent and control variables. The central measures, dispersion of study variables are shown in Table 4-1.

In descriptive statistics of study variables for all variables, central and dispersion parameters are calculated separately. CSR variable of firm with 900 observations has minimum, maximum and mean 0.00, 1 and 0.65. The numbers show that this variable follows normal distribution. The changes of variable distribution from the data mean based on standard deviation statistics is ranging 0 to 0.47. The dependent variable of discretionary accruals with 900 observations has minimum, maximum and mean -94.4, 0.65 and 62.60, respectively. The changes of distribution of the variable from the data mean based on standard deviation statistics is ranging 900 to 0.5. The dependent variable of operational discretionary cash flow with 900 observations has min, max and mean -94.4, 47.78 and 39.92, respectively. The changes of distribution of the mentioned variable from the data mean based on standard deviation statistics is ranging 0 to 5.52.
DEA METHOD

The data envelop analysis is a math planning method to evaluate the efficiency of decision making units (MDU) with many inputs and outputs. Efficiency measurement due to its importance in performance evaluation of a company or organization has been always considered by researchers. The concept of production function is a basis for the relations of inputs and outputs and this function of production indicates maximum outputs and is achieved by combination of input values. The difference of CCR and BCC models is regarding varied return to scale. Fixed return to scale means the outputs proportionate with the inputs.First step: The calculation of CSR of company of data envelop analysis model.Second step: After calculation of CSR coefficients for all firms in each year, it is required to calculated a social responsibility coefficient for sample firms by “data envelope analysis”. After calculation of CSR coefficients for all firms in each year, those firms whit high social responsibility than mean in each year, CSR=1 and the firms with low mean, we have CSR=0. In the next stage, for each hypothesis, four regression models are estimated as input and output-based bcc and input and output –based CCR.

<table>
<thead>
<tr>
<th>Hypothesis No.</th>
<th>Hypothesis explanation</th>
<th>Relationship</th>
<th>Result of test</th>
</tr>
</thead>
<tbody>
<tr>
<td>1, 2, 3</td>
<td>There is an association between performance stability coefficient of firms and positive/negative/absolute value of discretionary accruals.</td>
<td>Positive and significant</td>
<td>Supported</td>
</tr>
<tr>
<td>4</td>
<td>There is an association between performance stability coefficient of firms and discretionary operational cash flows.</td>
<td>Positive and significant</td>
<td>Supported</td>
</tr>
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<td>5</td>
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<td>Positive and significant</td>
<td>Supported</td>
</tr>
<tr>
<td>6</td>
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<td>Supported</td>
</tr>
</tbody>
</table>

Table 1.2 The regression results of output-based bce

<table>
<thead>
<tr>
<th>Estimation of hypothesis 1, 2, 3</th>
<th>Durbin-Watson statistics=1.76</th>
<th>F statistics=3.41</th>
<th>R2=0.53</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>F statistics=15.99</td>
<td>R2=0.65</td>
<td>P-value=0.0000</td>
</tr>
<tr>
<td></td>
<td>F statistics=45.93</td>
<td>R2=0.82</td>
<td>P-value=0.0000</td>
</tr>
<tr>
<td></td>
<td>F statistics=1.88</td>
<td>R2=0.84</td>
<td>P-value=0.0000</td>
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<td>Supported</td>
</tr>
</tbody>
</table>
Table 1.8 The regression results of output-based CCR

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<td>Supported</td>
</tr>
<tr>
<td>4</td>
<td>There is an association between performance stability coefficient of firms and discretionary operational cash flows.</td>
<td>Negative and significant</td>
<td>Supported</td>
</tr>
<tr>
<td>5</td>
<td>There is an association between performance stability coefficient of firms and discretionary operational production expenses.</td>
<td>Positive and significant</td>
<td>Supported</td>
</tr>
<tr>
<td>6</td>
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<td>Negative and significant</td>
<td>Supported</td>
</tr>
</tbody>
</table>

Table 1.9 The regression results of input-based CCR

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CONCLUSION AND GENERAL INTERPRETATION OF THE RESULTS OF HYPOTHESES TEST

In this study, a comprehensive analysis on earnings quality with CSR of firms with emphasis on their performance stability coefficient was done by data envelope analysis. At first, the CSR of firms is done by DEA method and the result is as two output and input-based BCC return and input and output-based CCR in the second step, the data of DEA method are used to estimate in combined regression. This study includes six hypotheses and t-statistics is used for regression analysis. To evaluate the significance of regression models variables, the second square of data during the years are used. The empirical evidences of hypotheses test showed that among the discretionary accruals, operational cash flow and discretionary operational and production costs had significant relation with stability coefficient of performance. Thus, there is a positive and significant association between earnings quality and CSR and it is in line with the findings of study of Kim et al., (2012), Benson et al., (2011), R. T Call et al., (2009) and Perior et al., (2008). As shown in the following Table, CSR with emphasis on stability of performance in varied return to output-based scale has direct and significant relation with accruals, operational cash flow and discretionary production and operation expenses. CSR with emphasis on performance stability in varied return to input-based scale has direct and significant relationship with accruals, operational cash flow and discretionary production costs and it has inverse and significant relationship with discretionary operational costs. CSR with emphasis on performance stability in fixed return to output-based scale has direct and significant relationship with accruals and discretionary production costs and it has inverse and significant relationship with discretionary operational costs and operational cash flow. CSR with emphasis on performance stability in fixed return to input-based scale has direct and significant relationship with accruals and operational cash flow and it has inverse and significant relationship with discretionary operational costs and discretionary production costs. The findings of the study showed that there was a relationship between earnings quality and CSR with emphasis on the performance stability, it has significant relation with the evaluation models applied in the study including discretionary accruals (negative, positive and absolute value), operational cash flow, discretionary operational and production costs. It is worth to mention, that the highest impact between the changes of earnings quality with CSR among the study criteria is discretionary operational cost. The changes of earnings quality determine 84% of discretionary operational cost. Also, in this study, the variables including firm size, value book to equity market ratio, adjusted ROA, great auditors, financial leverage and establishment duration are considered as independent variables and each has significant impact on the results of regression in each of study hypotheses. Some of the researchers referred to the impact of unique conditions of each firm as size, type of industry on relations of profit, occurrence of each of above conditions is an important factor in the relevant studies (Qanbari Moghadam, 2013). In this study, it can be said that adding or reducing each of the mentioned variables affected the test statistics and test probability and it led into the more significance and relations of earnings quality with CSR with emphasis on their performance stability.

Table 1.10 The summary of study findings and results

<table>
<thead>
<tr>
<th>Independent variable</th>
<th>Accruals</th>
<th>Operational cash flow</th>
<th>Discretionary production costs</th>
<th>Discretionary operational costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>CSR-BCC output-based</td>
<td>Direct and significant</td>
<td>Direct and significant</td>
<td>Direct and significant</td>
<td>Direct and significant</td>
</tr>
<tr>
<td>CSR-BCC Input-based</td>
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<td>Direct and significant</td>
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</tr>
<tr>
<td>CSR-CCR output-based</td>
<td>Direct and significant</td>
<td>Inverse and significant</td>
<td>Direct and significant</td>
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<td>Direct and significant</td>
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</table>

STUDY RECOMMENDATION

Applied recommendations of study

The results of study showed a strong and effective relationship between earnings quality and CSR with emphasis on stability of the performance of the stock market firms during 2002 to 2011. Thus, the investors and analysts of market can identify the firms with high earnings quality by the results of study. As discretionary operational cost is one of the important factors on earnings quality, based on...
the results of estimation, it is recommended to managers of firms, to maximize earnings quality for shareholders, by reduction discretionary expenses, the reported profit is increased.

**Recommendations for further studies**

By conducting a study, a new path is opened and continuing the way requires conducting other studies. Based on the topic in this study, the following recommendations are presented for future studies. As the present study is performed in the definite period, the study can be done in other time periods. The present study investigated the discretionary accruals, it is recommended that in other study, non-discretionary accruals and accruals and cash components can be investigated generally. The present study investigated the size of accruals. It is recommended to investigate quality of accruals in this regard in a study. In this study, the results are investigated for all industries. It is recommended that this study is investigated and tested among the various industries as separately. In this study, the criterion of ROA and sale growth is used for profitability criteria. It is recommended that the impact of other profitability criteria on relationship between earnings quality and CSR is investigated and tested.

**STUDY LIMITATIONS**

1-Regarding the impact of CSR items with emphasis on performance stability on accruals, operational cash flow and discretionary operational and production costs, the empirical research has not been conducted in this regard by the existing variables and the relationship between earnings management and accruals is investigated. Thus, the shortage of information resources is clear in this study.

2- One of the limitations of the study is non-disclosure of some of the required data in financial reports of the investigated firms and it is not used in the adjustment and in case of the required information, the results of study can be different.

**REFERENCES**


statement items with the value of company in the firms listed on TSE. MA thesis. Sistan and Baluchestan University.


