Corporate Social Disclosures and Accounting Theories

An Investigation

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Abstract

This study reviews the use of accounting theory in explaining corporate social disclosure behaviour. The synthesis research of accounting disclosure and corporate social responsibility research is examined. Specifically the use of the positive accounting theory is analysed, but also critical studies on the use of this theory. Also legitimacy theory was used in the past as the theoretical basis for corporate social disclosures, which is also discussed on its merits. Voluntary accounting disclosure research, which has not been used to explain social disclosures in the past, is examined for its usefulness. The combination of social disclosures behaviour and voluntary accounting disclosures turns out to be a promising new field of research.

Preface

Corporate Social Responsibility (CSR) and its related disclosures have been on the research agenda since many years. The CSR-research was stimulated by the hopes that society could benefit from it (Margolis and Walsh 2003). The more than 30-year[1] search for a relationship between corporate social performance (CSP) and corporate financial performance (CFP) has not brought much consistent proof of any clear motive for corporations to get involved in CSR. This could have fed the hope for society that companies really were willing to do well for society. According to Margolis and Walsh (2001), the lack of clear proof is due to a non-existing theoretical foundation of the empirically revealed relations between CSP and CFP. The questionable quality of the performed research was also mentioned by Margolis and Walsh. They reviewed all kinds of possible studies on relationships between CSP and CFP. They refer to the tension between the different roles of the corporation, while pursuing financial or social goals. Margolis and Walsh look at this problem from an organisational perspective, but they also included accounting related studies in their review. They refer to CSR as a broad concept for which an overall theory is needed. Their article has not often been identified in the social accounting research branch. In contrary to Ullmann (1985), whose critical article has often been cited in social accounting and disclosures research studies. Ullmann has a narrower focus, the financial accounting approach to the CSP-CFP-social disclosure relation, which is useful for this paper.

Introduction

The objective of this paper is to provide possible direction for a theoretical foundation of the research for the relation between disclosed CSP and CFP. These are further called social disclosure studies[2].

The structure of the paper is firstly to provide overviews of existing literature of two research area. In the concluding part there is a proposal of how the area of financial accounting research might be able to support the area of corporate social disclosure research to find new theoretical directions.

This paper starts with the developments in social disclosure studies, according to reviews of the literature and the categorisation of research studies. Studies that discuss the applied theories, specifically legitimacy theory (LEGT) and positive accounting theory (PAT) are analysed. Furthermore, financial accounting theories and financial accounting paradigms are described, according to Belkaoui's financial accounting research taxonomy (Belkaoui 2000). Additionally overviews of accounting research by Scott (2006, first edition 1997) and additions by Healy and Palepu (2001) and are given next to Belkaoui's taxonomy. After combining all available research overviews the concluding analysis suggests on the financial accounting research category which can be applicable in social disclosure research. This might give a new direction or the identification of a social accounting and disclosure paradigm[3]. The discussion on social disclosures will be limited to public disclosures, which excludes private disclosures. This paper also assumes social disclosures to be voluntary, which is the predominant situation (Deegan 2002).

Social Disclosure Studies: Reviews and Categorisations

Ullmann (1985) contributed some important new insights to CSR research. He writes about methodological and theoretical problems that are still valid. Ullmann criticises research that was previously performed and new research directions are proposed. Ullmann reviews articles and classifies them based upon models of relationships between (1) social performance and social disclosure, (2) social performance and economic performance and between (3) social disclosure and economic performance. A large problem faced by these studies is the conceptualization and operationalisation of key issues, in which there is no consensus on methodology and results between the studies. For the relation between economic and social disclosure, a distinction between "Friedman-type" investors and ethical investors needs to be made. The first will reward social performance negatively, the latter positively. In efficient markets, stock prices, as a possible performance indicator for economic performance, must also reflect all disclosed information on social issues. Other variables used in research are accounting variables. Ullmann states that it is not clear, whether models that are used in financial disclosure studies can be used for social disclosure analysis. The ambiguous results of the reviewed research assume that the models have not been applied consistently. Another research direction is needed. The nature of the relationships between social disclosures and economic and social performance need to be studied taking into consideration company strategy, focusing on how companies deal with stakeholder demands. A contingency model is proposed using stakeholder power and strategic behaviour variables. The contingency approach means that, linked to strategic behaviour types, relations between economic and social performances and social disclosure need to be researched. The model suggests that differentiation is needed between voluntary and non-voluntary disclosures.

Gray, Kouhy and Lavers (1995) have provided a much cited[4] categorisation of corporate social and environmental disclosure studies. Other authors have not questioned this categorisation. Gray, Kouhy and Lavers talk about three broad groups of theories concerning organisation-information flows. They do not explain the choice for the categories. The following categories are identified by them:

1. Decision Usefulness Studies, which partly overlap with categories 2 and 3[5]
2. Economic Theory Studies
3. Social and political theory studies

Gray, Kouhy and Lavers explain decision-usefulness studies by describing some studies and their results. The decision usefulness generally relates to the usefulness of accounting information, which is social accounting information in this case. These studies are of two types, ranking of information on its perceived decision-usefulness in the financial community and investigations of information on effects on share prices. Gray, Kouhy and Lavers state that decision-usefulness studies lack a theoretical backing. Furthermore they proclaim the discrepancy between the corporation's non-financial motives to get involved in CSR and the needs of the financial stakeholders, which are predominantly financial, as being the main problem. The discrepancy is seen like this by the academic community and Gray, Kouhy and Lavers assume that managers agree on this with the academics. This problem makes, according to Gray, Kouhy and Lavers, the outcomes of studies that prove the decision-usefulness for financial stakeholders unsatisfactory, in case of financial decision usefulness.

Gray, Kouhy and Lavers mention that decision-usefulness studies do not really deal with theories. They simply say that there is a lack of theory in this theoretical category, which is a contradiction. Decision-usefulness in the field of financial accounting is seen as a separate branch of research. One of the two types of decision-usefulness studies, aggregate markets studies (Belkaoui 2000), uses efficient market theory. Other studies within this category of decision-model studies do not apply a clear theory, but can be seen as a separate methodological branch. This briefly shows that theory application might be possible, although the use of theories with strong economic ties is said to be conflicting with CSR.

Economic theory studies have been a response to the unsatisfactory[6] decision-usefulness approach. Social disclosure studies, using economic theory, have been in the periphery of agency theory and PAT research. Gray, Kouhy and Lavers (1995) see no need to analyse this research category. They are very negative about the benefits to social disclosure studies by these theories. Their main concerns are the collision of free market thinking from the economical perspective with the market-failure approach by the CSR community and the desire to change "current practice". He also states that short-term self interest, as the practical implication of pure economic rationality, is highly implausible as motivation for CSR-actions. Political theory studies exist of studies which apply LEGT and Stakeholder Theory (STAKT). LEGT, and to a lesser extent STAKT, has been used often in the last years in social disclosure studies. The use of these theories can be explained with the notion of many authors (Gray, Kouhy and Lavers 1995, Neu, Warsame and Pedwell 1998 and Van der Laan 2006) that firms, or in a broader sense organisations, are part of society as a whole, or even have a contractual relationship with society (Patten 1992). This notion might conflict though, with "Friedmanian" wealth-maximising behaviour. Gray, Kouhy and Lavers' remarks on social disclosure studies using LEGT, is provided with the discussion of LEGT below.

In 1989 Belkaoui and Karpik publish a much-cited study that develops and tests a positive model on the corporate decision making on social disclosures, linked with social and economic performance. They use the categorisation by Ullmann (1985). The employed theory is PAT. Belkaoui and Karpik are not fully consistent in using PAT, as it only tests the political cost hypothesis and debt covenant hypothesis and not the bonus plan hypothesis. They do not clarify why they ignore these hypotheses. Milne (2002) assesses Belkaoui and Karpik's article critically. Although focusing on PAT, Milne also provides broader comments on the use of theory. He states that in Belkaoui and Karpik's work is difficult to distinguish the use of PAT from other theories, as LEGT and STAKT. Further discussion on the use of PAT will be given below.

Positive Accounting Theory and Social Disclosure Studies

In their 1979 work Watts and Zimmerman mention corporate social disclosures, as a minor issue. They mention in their 1978 paper (p.115): "… corporations employ a number of devices, such as corporate social responsibility campaigns in the media, government lobbying and selection of accounting procedures to minimize reported earnings."

Already in 1981 Trotman and Bradley show some interesting applications of PAT in combination with social disclosures. One of their main limitations was though, that they only used PAT's size hypothesis, without properly explaining why they used only this part. Next to size form PAT, they tested risk, management's decision horizon and social pressures. The latter might be seen as the use of LEGT, but was not clearly acknowledged as such. One of the important conclusions was that managers involved in CSR have a longer decision horizon.

Milne (2002) has not only criticised Belkaoui and Karpik in using PAT as their theoretical foundation, but the use of PAT in social disclosure studies in general as well. He discusses the development of PAT by Watts and Zimmerman (1978, 1979 and 1986) and links this to social disclosures. Only in their 1978 article Watts and Zimmerman refer to social responsibility. Social responsibility/disclosure has not been an important issue in the work of Watts and Zimmerman. In 1978 they assume that individuals, and consequently management act to maximize their own wealth. Only in some specific cases Watts and Zimmerman's work can be linked with CSR, through political costs, with examples from the oil industry. Their reference to social responsibility disclosures was based upon, 1978, the at that time popular advocacy advertising. This advertising only fits partially into their argument. It remains unclear if this lobbying is intended to reduce profits. In their theory though, Watts and Zimmerman state that, reducing profits is the clear objective of managers and so remove the source of public and political concern. The social disclosure and lobbying seem unlikely to aid management reported accounting numbers. Furthermore, advocacy advertisements against prospective legislation, is probably more successful than annual report social disclosures.

In 2003 a study by Patten and Trompeter has applied clear PAT –related models. These models ware based upon Cahan, Chavis and Elmendorf (1997). The latter article was again based upon general earnings management research by Jones (1991), which purely tests the political cost hypothesis of PAT[7]. In this rather recent work by Patten and Trompeter employs PAT, without discussing the fact only some limitations were raised, for example whether PAT and earnings management were a proper theory to be tested alongside social disclosures. Patten and Trompeter mention that they only examine accounting-related management choices on social disclosures and earnings management. This might be a weak form of the conclusion by, for example Gray, Kouhy and Lavers, that [financial] economic choices do not go well with CSR choices.

A remark needs to be made about the discrepancy that exists in combining social disclosure behaviour and management's choices for compulsory financial accounting regulation. That fact that Watts and Zimmerman (1978) mention social disclosures, which are predominantly voluntary, should not mean that how management deals with accounting regulation and may perform earnings management (Patten and Trompeter 2003), can be combined in testing the size hypothesis.

Legitimacy Theory and Social Disclosure Studies

Since the 1980's LEGT has been used by researchers, who where looking for explanations for social and especially environmental disclosures (Van der Laan 2006). She mentions limitations of LEGT, like a perceived legitimacy gap. This gap exists, because of differences between society's expectations and firm's social performance, which can be assumed not to be measured properly, nor perceived correctly. Although seen as a limited theory, due to its under-development, it might be justified to further employ this theory in the field of social disclosure research (Deegan 2002).

Social and political theory studies are the central focus of Gray, Kouhy and Lavers' article (1995). LEGT and STAKT are theories developed out of political economics. LEGT and STAKT are overlapping perspectives in a political-economic framework[8]. Gray, Kouhy and Lavers state that it seems to be impossible to study the "economic domain", without the political, social and institutional framework of society. Following out of this, is that the raison d'être for CSR (and its disclosures) must be that economical issues (financial, in case of corporations) are not the only relevant issues in society, and thus need to be combined with the social and political in doing business or reporting about the business.

Gray, Kouhy and Lavers seek much of their motives to plea for the use of LEGT[9] in political economy theory, partly based upon Marxist theory. In his 1970 article Friedman also uses

Marxist theory, but opposes against it. He came to the conclusion that CSR is something companies should not get involved with. He states that it can not be in the interest of the shareholder as residual claimant and wealth-maximising proprietor of the firm, according to neo-classical economic theory. Clearly, different theories lead to different conclusions. Some comments in the use of LEGT can be provided. The question can be raised why political economic theory was used and not any sociological theory, if one states that economical, political and social theories might be useful. For CSR specifically sociological theories might be more appropriate than political theories. On the other hand, applying only sociological theory might ignore the economic nature of corporations.

Financial accounting Theory Categories and Paradigms

This study tries to identify financial accounting theories to apply in social disclosure studies. Starting the analysis of the usefulness of these theories, several research categories, or paradigms are explored. Belkaoui (2000) describes with his taxonomy a categorisation method for financial accounting theories. These categories represent research paradigms. Belkaoui identifies six research categories or paradigms:

1. Anthropological/inductive theories
2. Deductive theories, or true-income
3. Decision-usefulness / decision model theories
4. Decision-usefulness / aggregate market behaviour theories
5. Decision-usefulness / individual user
6. Information-economics theories

According to Belkaoui (2000), each category is described in such manner that it can be classified as a paradigm. For each category four specific paradigm classifying components are identified:

a. Specific examples within this category
b. General thoughts on the research topic
c. Specific theories within this category

d. Applied research methods

An overview of the paradigms, with descriptions linked with questions a. to d. follows here.

The work of Watts and Zimmerman, specifically their contribution to PAT, is seen as an example of anthropological/inductive theories paradigm. The general attitude of advocates of PAT is that accounting practises are derived from and explained by practical usefulness and management's choices. Mainly empirical methods are used.

An important True-income/deductive illustration is the work of Edwards and Bell. In this research paradigm logical and normative reasoning were used to come to theories of true-income.

An example of Decision-usefulness / decision model theories is the work of Beaver, Kennelly and Voss. They wrote about predictability as a criterion to improve decision making based on accounting information.

Part of the Decision-usefulness / aggregate market behaviour theories paradigm is a 1974 article by Gonedes and Dopuch. In this paradigm efficient capital markets and the decision making of the individual investor with regard to aggregate capital markets are important. Finance theory, efficient-market hypothesis are the theoretical foundations.

The Decision-usefulness / individual user paradigm is linked to behavioural accounting research; how does the individual user of accounting information respond to this information. Accounting is seen as a behavioural science.

Information-economics theories are economic theory of choices and other economic theory with a focus on rational behaviour. Accounting information is seen as an economic commodity, with a market with demand and supply. The article by Feltham (1968) is an example, of the description of value of accounting information. Akerlof (1970) describes this issue also in relation to financial information, but describes a model for demand and supply of financial information. He mentions the information asymmetry between investors and managers. Stiglitz (2001) reviews information economics, although not specifically mentioning accounting information.

It can be concluded from this overview that there is currently no dominant research paradigm. The paradigms exist next to each other. Accounting is seen as a multiple paradigm science (Belkaoui 2000).

Scott (2006) also presents a categorisation of financial accounting theories. He identifies the following categories[10]:

1. Decision usefulness approach
2. Information perspective on decision usefulness
3. measurement perspective on decision usefulness
4. Economic consequences
5. Analysis of conflicts

Scott describes the categories and also explains how these came to existence. As the latter might be relevant for this paper, Scott's explanations are relatively extensively mentioned here. The decision-usefulness approach to financial accounting as a category relates to decision theory and investment theory. The latter assumes efficient security markets. Efficient Securities Markets; an issue that is mentioned here are voluntary disclosures, which are meant to get rid of undervaluation. Investors believe that firms are undervalued, as managers may have inside information. Information Asymmetry is seen by Scott as the most important concept in financial accounting theory, which refers to Akerlof (1970).

The information perspective on decision usefulness has dominated financial accounting theory and research since Ball and Brown's (1968) article, which only recently has changed to a stronger focus on the measurement perspective on decision usefulness. The information perspective on decision usefulness means that individual investors need useful information to predict future company performance. It assumes that securities markets are efficient and that the markets will react to useful information.

The measurement perspective on decision usefulness focuses on the reliability of information and the usefulness of the information to assist investors in predicting firm value. It is stated that more attention for measurement increases the usefulness of the information. This research branch assumes that securities markets are less efficient than believed before. Scott identifies as the relevant theories prospect theory and the clean surplus theory. The first is a theory linked to behavioral finance. The latter says that the market value of the firm can be expressed in terms of balance sheet and income statement variables (Ohlson 1987). This theory has led to studies of value relevance.

Research for Economic consequences is clustered around PAT-research, which was set-up by Watts and Zimmerman (1978, 1979, 1986) but this direction in accounting research was initially identified by Zeff (1978). Despite efficient market theory implications there is a belief that accounting and disclosure policy can have influence on firm value and therefore can affect manager's and other's decisions. Economic consequences research is linked with employee stock options and stock market reactions to accounting policy choices. PAT belongs to this category, according to Scott. He explains the economic consequences by stating that PAT is concerned with predictions of accounting policy choices and how managers respond to accounting regulation changes. A firm can be seen as a set of contracts, for which contracting costs will be minimized by the management.

Analysis of conflicts, in relation to financial accounting, uses models from Economic Game Theory and its branch Agency theory. Agency theory is type of cooperative game theory, modeled by an employment contract between manager and owner. In case of the agency theory, there is the implication that net income has to play a role in motivating and monitor manager's performance. Non-cooperative game models might provide insight in conflicting interests of different groups of users of accounting information. Other authors spread this category of analysis of conflicts contains theories that are over other categories. The nature of the theories is mainly economic, which makes the separate discussion of this category questionable. The conclusion of a multiple paradigm can also be drawn after the discussion on Scott's review of accounting research.

Healy and Palepu (2001) write about frameworks, instead of paradigms. They identify four main frameworks, which can be compared with the previously mentioned paradigm and categories of accounting research studies. The identified categories are as follows:

1. Regulation / standard setting
2. Auditors/intermediaries
3. Managers' disclosure decisions
4. Capital market consequences

What they added to the categorisation methods or taxonomies is discussed next. They partly distinguish their categories on the user of accounting information. They describe the category of regulation and standard setting research, which is different from the Scott and Belkaoui's approaches. Especially adding the research category manager's disclosure decisions might provide new insights. Within this category they discuss financial voluntary disclosures, which are extensively discussed in Verrecchia (2001) and Dye (2001). Within this sub-category they identified the credibility of financial voluntary disclosures, which are in many cases financial forecasts. The latter can be linked to the full disclosure concept and information asymmetry. This has been called information economics by others. Healy and Palepu's regulation and standard setting is seen as a separate category, which has strong ties with the capital markets category, because its focus on corporate value.

Synthesis of Social Disclosure and Financial Accounting Research

The three main research categories for social disclosures research (Gray, Kouhy and Lavers 1995) are the decision usefulness studies, economic theory studies and social and political theory studies. Per category the paradigm description components from Belkaoui (2000) are provided, which could classify these categories as research paradigms.

A much cited example decision usefulness studies in the field of CSR is Aupperle (1984). The general thoughts within this research category are that the financial community regards corporate social as somewhat useful with taking financial decisions, although the outcomes of the studies are inconsistent. There is not a clear theoretical foundation that supports this research category. The research methods are statistical, using regression models.

A specific example of the economic theory studies is the PAT-study by Belkaoui and Karpik (1989). The general thoughts are the existence of free markets and information asymmetry. There is a methodological pluralism within this category.

A clear examples of Social and political theory studies is the article by Patten (1992). Patten clearly uses LEGT in his explanations, but the tested model is a combination of Trotman and Bradley's work (1981) and PAT's size hypothesis (Watts and Zimmerman 1978). Trotman and Bradley do not clearly apply theory. The foundations of LEGT are provided by Preston (1975). STAKT is mentioned in several review articles as a useful theory in the field of social disclosure studies, but there is no clear example o testing this theory in relation to social disclosures. STAKT research assumes the necessity of stakeholder's support for continuation of businesses. Mentioned before is the general idea behind LEGT, a contract between the firm and society. Applied research methods are mainly statistical, with inconsistent modelling.

Briefly analysed, it can be said that none of the three categories has been fully developed. There might be doubts in calling these full paradigms, especially due to a lack of theoretical foundations.

Concluding Comments

A theoretical foundation of corporate social disclosures is not easily identified. Several theories from political economy and other economic theories were applied in the past. Legitimacy theory is currently the most important theory in social disclosure studies. Although it seems to be linked to social issues it is a political-economic theory. It is a rather underdeveloped theory. The theory is seen as a contract with society, as firms are seen within this research as a part of society as a whole.

Other research studies, even very recent ones, have employed Positive Accounting Theory as their theoretical foundation. This theory is never been tested fully in this field, only the size or political cost hypothesises. This theory assumes certain social characteristics, but it is an economic theory in essence. The discussion whether economic theories or rather social theories should dominate corporate social disclosure research will not be concluded easily. If corporations are involved in corporate social responsibility, they will at most incorporate this in their current business model. They will not themselves regard their corporate social responsibility activities as their core objective, in those days on which the wealth-maximisation business paradigm still rules.

While corporations seek combinations between their wealth-maximisation and social objectives, researchers need to do as well. Legitimacy theory, just to assess the contract with society seems to be one-sided, only political-economic. A theory that supports the assessment of how corporations are able to combine these objectives might be a way to go forward. In case of social disclosure research, this might be area's in which already much experience is gathered, but where no social disclosure research was performed yet. Like financial accounting research, social disclosure research is done in a multiple research category setting. Describing it as a multiple research paradigm science assumes a stronger developed research area than what has been done so far.

The paradigms in financial accounting are similar, but differ from the research categories in social disclosure studies. The main difference exists with regard to true income, anthropological studies and information economics. True-income must be irrelevant, because of its pure financial focus and its old-fashioned normative character. Anthropological studies are currently outside the scope of this paper. These studies are specific on methodology, and not on theory itself, which is necessary for this paper.

Information economics has been identified as a financial accounting research paradigm by Belkaoui (2000). Healy and Palepu (2001) discuss the issue of the information asymmetry, which can be seen as a field of research closely related to information economics. Information economics has not been identified as a separate field of social disclosure studies. Van der Laan (2006) though mentions the issues that are currently on the research agenda of voluntary disclosures. She states that the research agenda consists of credibility, standardisation and accessibility of voluntary disclosures. Worthwhile mentioning is that Healy and Palepu (2001) say that two of these issues, credibility and standardisation, appear on the financial accounting research agenda of voluntary disclosures as well[11]. The issue relates to credibility of information, which can be enhanced by auditors. Auditing of social disclosures needs a consensus on corporate social performance first, before this information can be relevant to its users. This seems to be a key issue, which is supported by research for standardisation of social accounting and disclosures. Standardisation might support the improvement of social performance scoring systems, or social accounting. However, if the goal of social disclosure research is to look for objectives for corporate social disclosures, then regulation and standardisation research provides a totally different direction.

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Notes

[1] When CSR research was done for the first time is unclear, as is the start of the search for relations between social and economic performances and disclosures. For the first type Ullmann (1985) sets 1957 as the start. Gray (2001) mentioned the beginning of the 1970's for the second type.

[2] In many studies this research branch is called Social and Environmental Disclosures, which for this study is assumed the same, as being the information flow from the company to its stakeholders about CSR. CSR contains environmental and social issues.

[3] For the definition of research paradigm there is referred to Kuhn, T.S., The Structure of Scientific Revolutions, University of Chicago Press, 1962 and 1970 editions, cited in Feenstra (2001).

[4] At least cited in Deegan (2002), Gray (2001), Hooghiemstra (2000), Milne (2002), Patten (2002), and Van der Laan (2006).

[5] According to Gray, Kouhy and Lavers (1995) there is an overlap. The overlap is not specifically explained.

[6] Gray, Kouhy and Lavers mention the unsatisfactory status, after their critical assessment, but it can be agreed upon in line with the analysis this paper.

[7] Political cost hypothesis is derived from the size hypothesis.

[8] Regarding this definition, Gray, Kouhy and Lavers quote Arnold, P.J., 1990, "The state and the political theory in corporate social disclosure research: a response to Guthrie and Parker", Advances in Public Interest Accounting, vol. 3, pp 177-181 and Guthrie, J.E., L.D. Parker, 1989, "Corporate Social Reporting: a rebuttal of legitimacy theory", Accounting and Business Research, vol. 9, No. 76, pp. 343-352

[9] As part of the social and political studies only LEGT will be discussed, due to the relatively large overlap with STAKT and the larger availability of studies.

[10] Scott does not specifically identify paradigms, but deals with categories of theories in separate chapters.

[11] The actual issue by Healy and Palepu was regulation and not standardisation. In case of social disclosures, there is not much regulation. Standardisation can be seen as a first step in the direction regulation.