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Corporate Social Responsibility, Shariah-Compliant and Earnings Management

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ABSTRACT

This paper investigates the relationship between Corporate Social Responsibility (CSR) and Financial Reporting Quality (FRQ). It also examines the effect of Shariah screening processes on the relationship between CSR and FRQ. Specifically, it investigates whether CSR firms that are Shariah-compliant engage in CSR as moral obligations and behave ethically in terms of providing high-quality financial reporting compared to CSR non-Shariah-compliant firms. The sample is constructed based on Thomson Reuters ASSET4 and FTSE Shariah index, having a sample of 4085 firm-year observations domiciled in Europe for the period of 2003-2011. We find a positive association between CSR and FRQ. The findings also evidence that CSR in training and development, diversity, human right, community, resource reduction and emission reduction have a significant influence on mitigating a firm's opportunistic behaviour of managing earnings using accruals. The results show that CSR firms that are not Shariah-compliant are less likely to manage earnings through accruals compared to CSR Shariah-compliant firms. This suggests that Shariah screening processes appear to have no effect on mitigating the opportunistic behaviour of involving in CSR activities for the purpose of managing earnings. This finding does not support the argument that Shariah compliant firms conducting their activities in ethical and transparent manner. This study provides a new and far-reaching addition to prior literature by assessing the association between CSR and FRQ, and the impact of Shariah screening processes on mitigating managerial opportunisms of engaging in CSR and earnings management activities. This also contributes to the growing discussion on CSR and FRQ from an Islamic ethical perspective.

Keywords: Corporate social responsibility, Shariah-compliant investments, earnings management, transparency in financial reporting.