How Corporate Social Responsibility Affects Audit Fees

Mónica LópezPuertas- Lamy December 15, 2017

The past two decades have witnessed a dramatic increase in firms' engagement with Corporate Social Responsibility (CSR) in response to the needs and expectations of a wide range of stakeholders. CSR practices can be understood as voluntary steps to improve social or environmental conditions. Examples of CSR practices include offering employees child day care or paid parental leave, reducing the carbon footprint or donating to charity. Together with the increasing attention, an important debate about CSR has emerged between two opposing sides. Proponents of CSR argue that socially responsible practices can have a positive impact by enabling firms to secure and retain critical resources controlled by various stakeholders, and by improving the firm's ability to avoid or reduce the impact of negative events. In contrast, opponents, such as Milton Friedman, have argued that corporations benefit society most by distributing profits to owners, who can then make charitable donations or take other socially responsible actions as they see fit. Other critics warn that managers may use CSR opportunistically to increase their own reputations and standing within social circles, to further political or career agendas, or to create an impression of transparency and ethical behavior among stakeholders while covering up corporate misconduct.

Building on these opposing perspectives, prior studies have examined the link between CSR and (post-audit) financial reporting quality, providing mixed results. In a new study, we investigate whether, and how, firms' CSR influences the auditors' assessment of the risk of material misstatement in financial statements. We extract the auditors' assessment of the risk of material misstatement from audit fees, which reflect the amount of effort that the auditors expect to spend on the audit. Higher audit fees should reflect, in the auditor's view, a greater risk of material misstatement or, in other words, a lower pre-audit financial reporting quality of the firm. Understanding the implications of CSR on the auditors' assessment of the risk of material misstatement is important for academics and policymakers, since this assessment affects the auditors' effort and evaluation of evidence and ultimately the (post-audit) firms' financial reporting quality.

Auditors assess the risk of material misstatement by gaining an understanding of the entity and its environment. In doing so, the auditor obtains, among other things, an understanding of the entity's objectives and strategies, and of those related business risks that may result in risks of material misstatement. The business risk is broader than the risk of material misstatement, though it includes the latter since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements.

We argue that the relationship between CSR and audit fees is quadratic, i.e., there is an optimal level of CSR that minimizes the auditor's assessment of the risk of material misstatement. For firms with a relatively low level of CSR, an increase in CSR is likely to reduce the firm's business risk and the auditor's assessment of the risk of material misstatement by a) enabling the firm to secure and retain critical resources controlled by various stakeholders and b) improving the firm's ability to anticipate the future and avoid negative consequences. As CSR continues to increase, however, this reduction of business risk will level off. At a certain level of CSR, further improvement will increase the auditor's assessment of the risk of material misstatement by increasing a) the firm's business risk (due to constraints on stakeholder support, direct costs, increasing risk of failing to deliver upon CSR promises, and stakeholders' concerns about the existence of agency problems within the firm); and b) the auditor's concerns about the opportunistic use of CSR.

Moreover, we posit that fast-changing business environments, ownership concentration, and large amounts of debt are likely to moderate the relationship between CSR and audit fees by influencing the auditors' assessment of the risk of material misstatement associated with a given level of CSR.

Using a comprehensive international sample of listed firms from the most relevant stock market indices over the period of 2003-2012, we provide support for our conjectures. In particular, the regression estimates indicate that audit fees are at a minimum level when the CSR score (which moves between 0 and 1) is equal to 0.35. Below (beyond) this point, audit fees decrease (increase), in an economic and statistically significant way, for each marginal increase in CSR. Consistent with our expectations, we also show that the optimal level of CSR increases for firms in changing environments and for firms with higher degrees of ownership concentration or leverage.

To the best of our knowledge, our study is the first to explore the link between CSR and audit fees and to propose a U-shaped relationship between these two variables. Our findings may help to refine the traditional models of audit fees and add to the debate on the link between CSR and financial reporting quality by pointing to the auditor effort as one mechanism through which CSR may influence post-audit financial reporting quality.

This post comes to us from Professor Mónica LópezPuertas-Lamy at Universidad Carlos III, Madrid (Spain). It is based on a recent article by her and Kurt Desender and Mircea Epure, "Corporate Social Responsibility and the Assessment by Auditors of the Risk of Material Misstatement," available [here](#).