How Corporate Social Responsibility (CSR) Helps/Hurts Market Reactions to Scandals

Jay Janney, Ph.D.
Co-authored with my friend, Steve Gove, Ph.D.

• Dedicated to the one journal editor who wasn’t so awful!

(But why does he keep asking about my 1st born son’s 18th birthday?)
A Lucky Break

- In 2006 the Stock options backdating scandal erupted all at once.

- After reading 903 articles, we captured info on 137 firms!

- We had one scandal, at one time, with lots of firms!
So what are we doing here?

• What happens when a publicly-held firm undergoes a scandal?
  – How does their prior reputation affect perceptions of the scandal?
  – How do their reactions affect perceptions of the scandal?
Framing this presentation

• Background on the Stock Options Backdating scandal
• Theory development
• Explaining the empirics
• Contributions
• Future Research
Background on Stock Options

• A stock option is the right to buy one share of stock, at a pre-set price, into the future

• As a recipient, you’re betting the future stock price will go higher than the pre-set price
  – If it does, you’re rich!
In 1993, the populists were mad!

So Congress passed a law limiting tax deductibility of executive compensation to $1 million

  Unless it was performance based: then you could award more and it was still tax deductible
Here’s an Example

• In 2002 Apple chose to award Steve Jobs a $1 dollar salary
  – Plus 7.5 million options at ≈ $18 per share
Remember Mark Hurd? NCR & HP

• His deal with Oracle calls for a $950k salary plus
  – A $5 million performance bonus
  – Options on 10 million Oracle shares

(I guess he landed okay)
Several academics noted something odd

• Almost all of these stock grants happened on day where the share price was at an annual low
Why would this matter?

• The lower the stock option award price, the more money the executive made!

• They wouldn’t be tempted to, ummm, cheat, would they?
And then suddenly, it stopped

Sarbanes Oxley required firms to post award grants within 72 hours of their award
–(used to be 9 months)
A colleague calculated the odds of

A firm awarding stock prices on the lowest priced day of the year, year years running

– About 1 in three trillion

• You’re 55 times more likely to win
Over 100 firms

- Restated earnings
- Fired executives
- Were investigated by the SEC/DoJ
Backdating

• Meeting on one day, but telling everyone you met before then

• Apple met on December 17\textsuperscript{th}, but told everyone they met on October 19\textsuperscript{th}
  – A $3 per share difference in Steve Job’s favor
Why did this matter?

• Apple’s board awarded Steve Jobs an extra $22 million in value, but deducted it from their taxes—(in violation of the law)
Key Insight

• By backdating, firms priced options so they had immediate value, not performance based
  – They misled investors, employees, and the Gov’t
This is a governance issue

• The BoD of these firms were responsible for this bad behavior

• It was a **governance** failure.
Now you know what backdating is, time to look at CSR
CSR is when firms go beyond the law in doing good

CSR appears to be cumulative (the more you do, the better your rep for doing so)

CSR is multi-dimensional

People identify with CSR reputations
Repeated efforts lead to more stable corporate identities

Healthier firms are better capable of doing CSR initiatives

People search for fit between themselves and the firms they interact with
Is it a trend or an aberration?

• Prior scandals will color current ones as being trends, not aberrations
Does a reputation for CSR help you in a scandal?

• Theory suggests that a reputation for CSR causes a scandal to be viewed as an aberration

• Theory suggests self disclosure is consistent with a reputation for CSR
What about timing?

• Earlier disclosure is consistent with CSR

• Later disclosure is consistent with reducing information uncertainty
So how did firms react?

• Some firms self-reported the problem
• Some firms were early in reporting
• Some had developed reputations for CSR

How did these effect market reactions?
Onto the Empirics!
Method

• We use an Event Study method where
  – We predict what a firm’s stock price should be on the day of the scandal
  – We compare it to the actual price on the day of the scandal
  – The difference is called an “Abnormal Return”

• We then regress the Abnormal Returns against control and explanatory variables
Why do all this?

Stock prices go up and down with or without new news about the firm being revealed.

We control for that random variation, leaving only changes that should be attributable to the event being studied.

We look at 2 day market reactions, a “CAR”
So what did we find?

- The markets reacted negatively to the scandal news, \( \approx 3.5\% \)
Overall CARs are negative -3.5%

Other non-surprising results
Moderating effects (non surprising part)

Self Disclosure is 2x better than being “outed”

Later Disclosure is 3x better than early disclosure
What does CSR do?

An overall reputation for CSR (measured by KLD) is 1.5x better than a low rep for CSR.

A high rep for CSR governance is 1.25X worse than a low rep for CSR governance.
Regressing the CARS

Control Variables
- Age
- Size
- Prior scandal
- Consumer industry
- Geographical proximity
- Percent Options granted
- Density

Moderating variables
- CSR Strength
- CSR strength in governance
- Timing
- Self disclosure
How to measure CSR?

KLD analytics is commonly used

They scour media for news about a firm engaging in both good and bad CSR
(bad being scandals, etc.)
KLD’s seven dimensions (our CSR measure)

1. Community
2. Corporate governance
3. Diversity
4. Employee relations
5. Environment
6. Human rights
7. Product

We measure both overall CSR strength and the governance strength.
## CARS Regression Results

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<tr>
<td>Age</td>
<td>CSR Strength</td>
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<td>Size</td>
<td>CSR strength- governance</td>
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<td>Prior scandal</td>
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- **Age**: 0.1
- **Size**: 0.1
- **Prior scandal**: 0.0001
- **Consumer industry**: no
- **Geographical proximity**: 0.01
- **Pct Options granted**: 0.05
- **Density**: 0.01

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A really intriguing finding

• High scores for CSR overall mitigate a scandal
• High scores on an individual CSR dimension exacerbates scandals related to that dimension

Because this was a governance scandal, a high score on CSR-governance results in sharply lower abnormal returns
A 2\textsuperscript{nd} intriguing finding

Firms with higher CSR scores tend to get “one strike” with prior scandals
A third intriguing finding

• Later disclosure has a milder reaction to scandal
  – Tested if the event was an “opening” or “closing” event on the scandal
  • Not significant, but we suspect that might explain the finding
Overall model adjust r2 is .3652

Adding KLD bumped it up 15 points
So what does this mean?

• Overall we explain about a 3\textsuperscript{rd} of the variance in the CARS (respectable)

• Validate that CSR appears to buffer firms somewhat in their first scandal

• Prior scandals suggest it is a trend, not an aberration
An example

• BP proudly proclaimed its “green stripes” as a friend of the environment
CSR is a two-edged sword

• People see your CSR as a commitment to a value: break that, and you shatter their identity with you

• If the scandal is in the same area as a high rep for CSR, it is viewed as hypocrisy, not an aberration
CSR helps people who want to believe in you!

• Because of their heightened affect, a scandal feels like a betrayal.
Chose in advance which values matter most!

• Develop an organizational culture that celebrates those values, and reinforce how important an individual value is!
Future Research

• Is it cholera or a quarantine? How do markets react to firms linked to the scandals of other firms?

• The Jonah Syndrome:
  – How do firm reputations tenure after a scandal?

• Typhoid law firms: linkages from shared legal counsel
How much of a penalty did firms pay?

• Average restatement was $50-125 million

• Average fine was $7 figures
Steve Jobs was a different story

Al Gore (an Apple BoD) intervened, and negotiated a deal

No prosecution if Steve returned all the options

7.5 Million options at $18 per share
But those shares are worth $303 today

He gave up $2.2 Billion in stock options

(he’ll be okay; he has about $6 billion left)
Thank You?