OUR KNOWLEDGE COMES FROM RESEARCH.

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

Jay Janney, Ph.D.

The Princeton Review BEST 2010 ENTREPRENEURIAL COLLEGES

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!

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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

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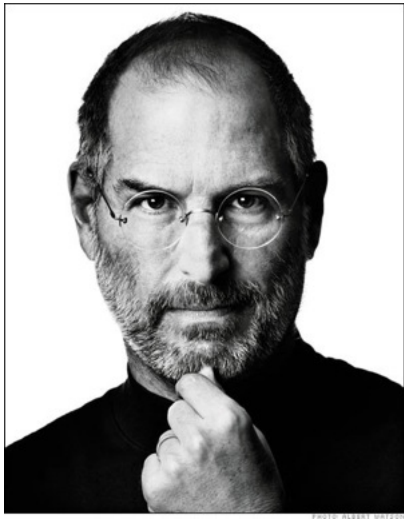
Here’s an Example

- 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

COURTESY: HEWLETT-PACKARD

- 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)

braucl0151s fotosearch.com

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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

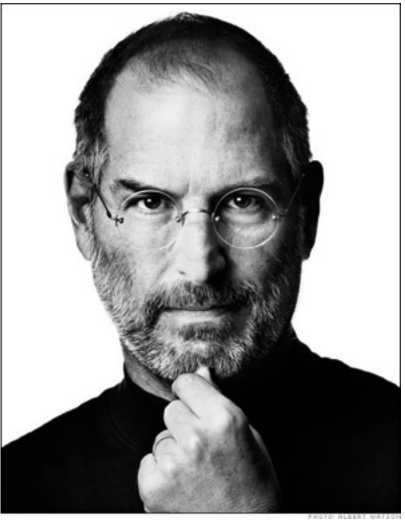
Over 100 firms

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

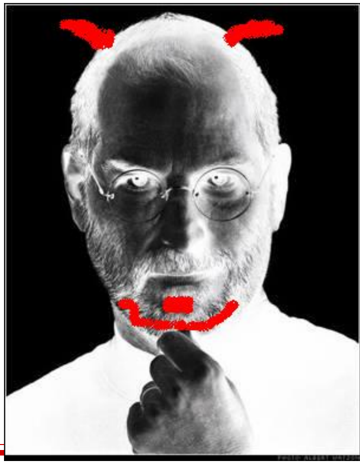
Backdating

- Meeting on one day, but telling everyone you met before then
- Apple met on December 17th, but told everyone they met on October 19th
  - 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

CSR & Identity

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 intereact 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

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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, ≈ $3.5%

Overall CARs are negative -3.5%

Other non-surprising results


The Dayton

Friday, November 19th, 2010

People worried Economy wil

Recent economic reports indicate most folks think "hell in a handbasket" is the most likely outcome of the government's latest efforts to right the titanic, umm, I mean economy.

People are seeking permits to add 4 story extensions to their homes, so they can be sure when they jump they'll splatter quickly and relatively painlessly.


The Dayton

Friday, November 19th, 2010

Violence in Middle East

Evil bad guys from "the other side" (editors: insert your side here) bombed the bajeezus out of the good guys, who were praying to God and minding their own business. Casualties were bad, but construction business is booming.


The Dayton

Friday, November 19th, 2010

Elvis Lives at KU!

Revealing he has been active getting his body back in to the shape of his early days, Elvis Presley ...peared in the Kennedy ...made some coeds, and borrow $25 for gas so he can get back to the limelight. Crooning "Love me tender", he also asked for credit card info, but was politely rejected.

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

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CARS Regression Results

Control Variables	Sig?
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

Moderating variables	Sig?
CSR Strength	.05
CSR strength- governance	.05
Timing	.05
Self disclosure	.01

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 2nd 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 3rd 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


Daytonian
Thursday April 21st, 2010
BP Oil Rig Blowout!
Of all the stupid things BPC could do, they forgot to check the safety process on a well a mile underground. I guess, since it ain't near their home in London, that they thought that they were close enough!


Daytonian
Monday 8 November 2007
BP Pipeline cracks, kills cari
Oops! The dips***ts at BP neglected to maintain their pipes; as a result thousands of animals have more oil on them than coeds at a spring break tanning contest! How hard is it to keep the pipes clean? I hope that someone shoves that pipe up BP's CEO's butt, and turns the spigot on full.

BP: Bringing oil to the American Shores!

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 restatememt was $50-125 million
- Average fine was $7 figures

Steve Jobs was a different story

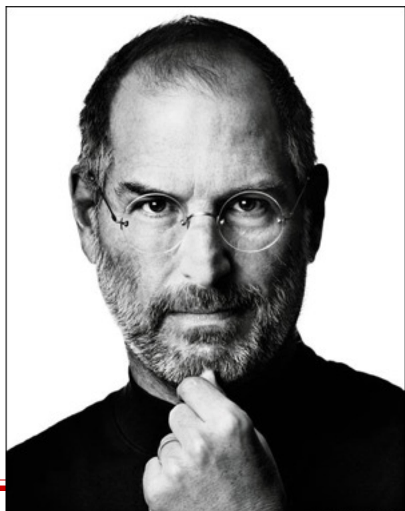
Al Gore (an Apple BoD) intervened, and negotiated a deal

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




AppleTalk

Sunday, August 30, 2006

Please help Steve!

Steve Jobs lost over $2 billion dollars, which is harder to lose than those pesky WMDs that W. left somewhere under the couch of the oval office. Do you realize there are five fewer 737s that jobs can buy today? Please give generously!

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

Thank You?

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