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Managers' green investment disclosures and investors' reaction ☆

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ABSTRACT

Although managers' green investments have no impact on future cash flows in our experimental markets, investors respond favorably when managers make and disclose an investment and highlight the societal benefits rather than the cost to the company. Managers anticipate investors' reaction and therefore often disclose their investment and the associated societal benefits. Managers and other shareholders benefit from investors' reaction, but the investment cost always exceeds this benefit, demonstrating that managers make green investments because they value the societal benefits. Collectively, our findings show that both investors and managers tradeoff wealth for societal benefits and help explain managers' corporate social responsibilty disclosures.

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1. Introduction

Although not required, most large companies now issue reports on corporate social responsibility (CSR) performance.[1] This voluntary disclosure of CSR activities is likely driven at least in part by a desire to communicate CSR information to investors. If CSR activities affect the company's future earnings and cash flows, investors will find related disclosures useful for their valuation decisions. However, it is possible that investors react to CSR disclosures for another reason as well. If investors value the societal benefits associated with CSR activities, they may respond positively to disclosures that the company has engaged in such activities independent of how they expect the activities to affect future earnings and cash flows. We conduct an experiment to test whether investors respond to managers' disclosure of their CSR investment independent of the effect on the company's future cash flows. In addition, we examine whether managers anticipate investors' response when making their disclosure decisions. Finally, we examine whether managers' CSR investment

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[1] Although most CSR disclosures are voluntary, domestic U.S. public companies are required to disclose any material risks resulting from the legislative, regulatory, business, market, or physical impact of climate change (SEC, 2010. Commission Guidance Regarding Disclosure Related to Climate Change).

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decisions are driven only by investors' expected response or also by their preferences for the societal benefits associated with their CSR investments.

Understanding how investors' respond to CSR disclosure is important because this can help explain managers' voluntary CSR disclosure practices. For example, knowing that investors value the societal benefits of CSR activities would help explain why managers' CSR disclosures tend to focus on such benefits. Also, knowing whether investors' reaction to CSR disclosures goes beyond the expected effect of CSR activities on the company's future cash flows could help explain the rapid growth in Socially Responsible Investment (SRI) funds (Social Investment Forum Foundation, 2012). More broadly, a more complete understanding of investors' reaction to CSR disclosure can inform standard setters who are considering whether CSR disclosures should be required, what information should be disclosed, and whether such disclosures should be audited.[2] Finally, understanding why managers invest in CSR activities helps inform the ongoing debate regarding whether all CSR activities must be shareholder value maximizing (Friedman, 1970; Karnani, 2010) or whether some such activities sacrifice profits in the social interest (Benabou and Tirole, 2010; Reinhart et al., 2008; Kolstad, 2007).

We examine a particular type of CSR activity, green investment to reduce carbon emissions, in an experimental market setting. There are several critical features of our setting that allow us to isolate the effects necessary to answer our research questions. First, in our experimental setting, the impact of a manager's green investment is fully reflected in the company's current earnings, and as such there can be no further impact on the company's future cash flows. This ensures that any observed investor reaction to disclosure of the green investment is not based on investors' expectations regarding how the investment will affect future earnings. Second, we ensure that both investors and managers in our experiment know that the financial cost to the company of a green investment always exceeds the financial benefit, i.e., the investment is always unprofitable. Thus, any green investment a manager makes always lowers shareholder value, and therefore any positive investor response to the disclosure of a green investment must reflect the investors' desire to reward the manager for engaging in an activity that the investors value.

We find that potential investors' standardized bids for the company are higher when managers disclose their green investments than when they do not, providing evidence that investors value the societal benefits associated with the investment. We also provide some evidence that investors respond more positively when managers' disclosures focus on the societal benefits of their investment rather than on the cost to the company. In addition, managers anticipate investors' reaction and thus overwhelmingly disclose their investment and tend to focus their disclosure on the societal benefits of the investment rather than on the cost to the company. Finally, despite investors' positive response to a disclosed green investment, both managers and current shareholders nevertheless bear a cost when the manager makes a green investment. Thus, managers' investment decisions must reflect the value they place on the associated societal benefits in addition to any expected investor response.

Our findings contribute to the CSR literature in several ways. First, our finding that investors' positive response to disclosures of a green investment are based at least in part on the societal benefits associated with the investments helps us better understand the rapid increase in SRI funds (Social Investment Forum Foundation, 2012). Second, our results offer insights into how and why managers disclose their CSR activities to investors. Third, our study helps inform standard setters who are considering possible CSR disclosure requirements. Finally, our study demonstrates the advantages of using experiments to examine important CSR issues that are difficult to study effectively using archival data.

In Sections 2 and 3 we provide background information and present our hypotheses. We describe our experiment in Section 4 and report our results in Section 5. The paper concludes with a discussion of our results and their implications in Section 6.

2. Background

The KPMG International Survey of CSR (2013) reports that 93 percent of the 250 largest global companies and 86 percent of the 100 largest US companies now engage in some type of voluntary CSR disclosure. If CSR activities affect the company's future earnings and cash flows, disclosing such activities will be useful for investors' valuation decisions. There are several ways that CSR performance could affect a company's future earnings. For example, being more socially responsible could add customers, increase sales, or increase pricing power (Lev et al., 2010), attract or motivate employees (Balakrisnan et al., 2011, Bhattacharya et al., 2008), lower the cost of equity capital (Dhaliwal et al., 2011) or reduce the risk of governmental regulation (Paine, 2000). Based on such arguments, researchers have often focused on establishing a positive association between CSR and measures of financial performance. Margolis et al. (2009) conduct a meta-analysis of 251 such studies over the last 40 years and conclude that "the overall effect is positive but small…and the results for the 106 studies for the past decade are even smaller." Of the 251 studies, 59% reported a non-significant result, 28% found a positive result, 2% a negative result, and the remaining 10% did not report sample size or significance.

[2] In addition to the traditional standard setters such as the SEC, FASB, and IASB, a number of other organizations have established or are working on establishing guidelines regarding sustainability reporting. Some notable examples include the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB).

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