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Can social responsibility reduce operational risk: Empirical analysis of Chinese listed companies

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ABSTRACT

After 30 years of rapid development, China has made great strides in economic growth but at the expense of high environmental and social costs. Listed companies should fulfill their social responsibilities not only to meet the expectations of stakeholders but also to improve management effectiveness, cultivate competitive advantage, create a good image, and achieve sustainable development. Because the influence of corporate social responsibility is expanding gradually in China, the relationship among listed companies' fulfillment of social responsibilities, information disclosure, and operational risk needs to be explored further. This study uses data on Chinese A-share listed companies from 2007 to 2009 and makes four main findings. First, listed companies improving their social responsibilities fulfillment face significantly lower operational risk. Second, listed companies publishing independent social responsibility reports face significantly increased operational risk. Third, high risk companies improving social responsibility fulfillment can significantly reduce their operational risk, while publishing independent social responsibility reports leads to significantly increased operational risk. Finally, low risk companies improving their social responsibilities fulfillment and publishing independent social responsibility reports experience changes in operational risk; however, the direction of the change varies by company. Companies with different operational risk have different effect because the company's majority shareholder is individual who lack of distinguishing news ability and CSR format is unified that is not enough to emphasize important disclosure issues.

1. Introduction

The idea of corporate social responsibility (CSR) formed in the early 20th century was initially linked to industrialization in the United States. However, as large companies with increased power in the economy and society have emerged, CSR has become a matter of concern for all companies. Firm's expansion makes the public pay attention not only the profit but also CSR. (KPMG, 2013) Indeed, since the 1990s, CSR ideology and stakeholder theory have presented a combined trend. Stakeholder theory provides not only a theoretical basis for the study of CSR, but also a suitable method for measuring CSR performance. The combination of these two theories thus dominates the traditional business objective of maximizing profit for shareholders and prompts companies to rather maximize the interests of all stakeholders (Freeman and Reed, 1983).

The past 30 years of rapid economic development in China has come at the expense of environmental and social costs. Therefore, the effectiveness of this development model needs to be reexamined thoroughly. For example, too much emphasis has been placed on economic growth, encouraging competition, and efficiency at the cost of fairness. In economic development, there is no corresponding emphasis on social development issues, which increases the risk of social unrest. Further, extensive economic development has entailed high energy consumption and high pollution and many local governments have exploited natural resources, damaging the ecological environment and even threatening national health.

To provide adequate growth while sustaining natural, economic, and social resources, China has proposed that publicly listed companies, as the most important part of the national economy, should become exemplars of social responsibility. A listed company that actively fulfills its social responsibility not only meets the expectations and requirements of stakeholders but also improves the efficiency and efficacy of its management, cultivates competitive advantage, creates a good image, and achieves sustainable development. CSR is not only the main way for companies to be involved in building a harmonious society but also an important guarantee of sustainable development. With the gradual expansion of the idea of CSR, the government's positive advocacy, and the community's active promotion, there is a positive trend among listed companies to fulfill their social responsibilities; indeed, the number of listed companies independently disclosing social responsibility reports is increasing annually.

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In China's capital markets, fulfilling social responsibility and reporting CSR performance started rather late compared with in western markets and a relatively large gap between the expectations of numerous stakeholders and market investors remains. Chinese scholars have successfully measured the correlations among listed companies fulfilling social responsibility and information disclosure, financial performance, valuation, profitability, and cost of capital. However, there are no studies of the correlation between CSR and operational risk. Based on the empirical evidence from listed companies in China, we examine the relationship between listed companies fulfilling social responsibility and disclosing the related information and operational risk as reflected by financial indicators. We also analyze whether high operational risk has a greater impact on fulfilling social responsibility and reporting disclosure information compared with low operational risk.

In this study, we use operational risk affected by internal and external stakeholders as the starting point and examine the correlation with CSR. This proposition expands the research perspective of social responsibility fulfillment and information disclosure and enriches the content of social responsibility accounting theory. The conclusion we reach is that the better companies fulfill their social responsibilities, the lower their operational risk is. Further, the voluntary publication of a social responsibility report has a significant impact on companies with relatively high operational risk. It helps listed companies actively improve and fulfill their social responsibilities.

From the perspective of operational risk control, this study provides strategic advice for disclosing the social responsibility reports of high risk companies. It highlights the important practical significance of encouraging Chinese listed companies to effectively fulfill their social responsibilities, improve governance, promote healthy and sustainable development, increase the efficient allocation of resources, raise the transparency of capital markets, and create a more harmonious capital market environment.

This paper has three contributions. First, Compared with the existing researches that focus on corporate value and financial performance, this paper focus on company's business risk, which has important practical significance. Second, corporate social responsibility management is divided into fulfillment and disclosure. This study shows that fulfillment can reduce the company's operating risk, however disclosure cannot. Third, the company should decide social responsibility management measures according to their characteristics, which means high business risks companies should pay more attention to social responsibility fulfillment.

The rest of the paper is organized as follows. The second section presents the theoretical analysis and research hypotheses, the third section discusses the research design, the fourth section presents the empirical results and analysis, and the fifth section concludes.

2. Theoretical analysis and research hypotheses

2.1. Literature review

2.1.1. CSR and stakeholder theory

CSR and stakeholder theory have developed as two mutually independent fields. The former discusses the company's responsibility to society and the latter is related to the relationship between various stakeholders and the company. Since the 1990s, these two theories have become fully integrated. On the one hand, stakeholder theory provides a theoretical basis for the study of CSR; on the other hand, research on CSR offers an empirical approach for stakeholder theory. Since the 1990s, many scholars have incorporated CSR into stakeholder theory as the basis for the empirical study of important issues such as the relationships between social responsibility and a firm's financial performance (profitability) and between social responsibility and firm value.

Johnson (2003) indicated that within a certain range, social responsibility can increase firm profits and enhance firm value. Socially undesirable and irresponsible behavior has negative effects on financial performance. Margolis et al. (2009) found a small positive correlation between CSR and financial performance, although they did show that this relationship is weak.

However, some research has reported the opposite conclusions. Elliott et al. (2013), for example, found that firm value is negatively associated with CSR. Lys et al. (2014) investigated the causality of CSR and financial performance to identify whether CSR is an investment or a signal. They found a positive correlation between CSR and future earnings and cash flows from operations but no statistically significant correlation between CSR and stock returns. They then showed that the positive correlation between CSR and earnings performance is driven by deviations from expected CSR. This finding is consistent with managers increasing CSR to signal their private information about strong expected future financial performance.

Much of the recent literature on the consequences of CSR provides evidence of the mechanisms by which CSR performance relates to firm value. Cho et al. (2013) examined the correlation between CSR performance and information asymmetry and found that both negative and positive CSR activities can reduce information asymmetry. This association only exists in firms with fewer institutional investors, suggesting that informed investors act upon information on CSR performance. Clarkson et al. (2013) showed that voluntary environmental disclosure can increase firm value by providing incremental information about the firm's competitiveness and expected future performance. Thus, environmental disclosure can be seen as a signal to investors (see also Lys et al., 2014).

Research on CSR and business risk has not been extensive. Dhaliwal et al. (2011, 2012) examined the cost of capital and showed that CSR disclosure can attract more analysts and institutional investors and reduce analyst forecast error, prompting a reduction in the cost of equity capital. However, Clarkson et al. (2013) did not find an association between environmental disclosure and the cost of capital.

Similar studies have been conducted in China. Li (2006) used data on 521 companies listed on the Shanghai Stock Exchange to study the relationship between CSR activities and firm value. The results showed that the higher the commitment of enterprises to social responsibility, the lower is firm value; however, in the long-term, social responsibility does not reduce firm value.

In sum, several domestic and foreign scholars have empirically examined the impact of social responsibility fulfillment and information disclosure on firm value, the cost of capital, and financial performance. Further, domestic scholars have identified the features that affect and measures that reflect operational risk. However, no domestic research has examined the relationship between listed companies' social responsibility fulfillment and information disclosure and operational risk. This study attempts to provide meaningful empirical results for this proposition.

2.1.2. CSR and corporate business risk

Research on social responsibility and corporate business risk has not been extensive. Casey and Grenier (2015) find potential benefits of CSR assurance to U.S. firms, including lower cost of equity capital, analyst forecast errors, and dispersion. Dhaliwal et al. (2011, 2012) examined cost of capital and showed that CSR disclosures can attract more analysts and institutional investors, avoid analyst forecast error, and reduce the cost of equity capital. However Clarkson et al. (2013) did not find an association between environmental disclosures and the capital cost. The difference between Clarkson et al. (2013) and Dhaliwal et al. (2011, 2012) suggests that CSR disclosure affects capital cost in a way that environmental disclosure does not.

The above study shows that several domestic and foreign scholars have empirically examined the impact of CSR fulfillment and information disclosure on enterprise value, capital cost, and financial