Journal of Banking & Finance 43 (2014) 1–13

Contents lists available at ScienceDirect

Journal of Banking & Finance

journal homepage: www.elsevier.com/locate/jbf

Corporate social responsibility and stock price crash risk ☆

Yongtae Kim *, Haidan Li, Siqi Li

Leavey School of Business, Santa Clara University, Santa Clara, CA 95053, United States

ARTICLE INFO

Article history:
Received 15 June 2012
Accepted 18 February 2014
Available online 25 February 2014

JEL classification:
G14
G30
M14
M40

Keywords:
Corporate social responsibility
Crash risk
Financial reporting transparency

ABSTRACT

This study investigates whether corporate social responsibility (CSR) mitigates or contributes to stock price crash risk. Crash risk, defined as the conditional skewness of return distribution, captures asymmetry in risk and is important for investment decisions and risk management. If socially responsible firms commit to a high standard of transparency and engage in less bad news hoarding, they would have lower crash risk. However, if managers engage in CSR to cover up bad news and divert shareholder scrutiny, CSR would be associated with higher crash risk. Our findings support the mitigating effect of CSR on crash risk. We find that firms' CSR performance is negatively associated with future crash risk after controlling for other predictors of crash risk. The result holds after we account for potential endogeneity. Moreover, the mitigating effect of CSR on crash risk is more pronounced when firms have less effective corporate governance or a lower level of institutional ownership. The results are consistent with the notion that firms that actively engage in CSR also refrain from bad news hoarding behavior, thus reducing crash risk. This role of CSR is particularly important when governance mechanisms, such as monitoring by boards or institutional investors, are weak.

© 2014 Elsevier B.V. All rights reserved.

1. Introduction

In recent years, corporate social responsibility (CSR) has emerged as a dominant theme in the business world. Many companies have expressed CSR commitments, initiated CSR projects, established CSR committees, and issued CSR reports. As CSR becomes a mainstream business activity, it is being promoted as a core area of management, next to marketing, accounting, or finance (Crane et al., 2008). In response to the rising popularity of CSR in practice, there is a growing multidisciplinary literature on CSR and its impact on firm actions and outcomes. A large number of studies have investigated the link between corporate social performance and corporate financial performance (e.g., Roman et al., 1999; Margolis and Walsh, 2001; Jiao, 2010; Kim and Statman, 2012). Other studies examine the association between CSR and firm risk (e.g., Lee and Faff, 2009). Some recent studies investigate the association between CSR and cost of capital (e.g., El Ghoul et al., 2011; Dhaliwal et al., 2011; Goss and Roberts, 2011).

In this study, we examine the relation between CSR and firm-specific stock price crash risk. Following Chen et al. (2001), we define crash risk as the conditional skewness of return distribution, rather than the likelihood of extreme negative returns.[1] Conditional skewness, like mean and median, is an important characteristic of return distribution. Unlike prior studies that focus on stock performance and firm risk, which capture the mean (first moment) and variance (second moment) of return distribution, we focus on conditional skewness, the third moment of return distribution. Crash risk captures asymmetry in risk, especially downside risk, thus is important for investment decisions and risk management. As discussed below, our study builds on prior research that attempts to predict firm-specific stock price crash risk and another stream of research that examines the relation between CSR and financial reporting transparency.

☆ We appreciate the comments and suggestions of Ike Mathur (editor), an anonymous reviewer, Yinghua Li, workshop participants at Santa Clara University, and the reviewer and participants of the 2012 American Accounting Association Annual Meeting. Parts of this paper were completed while Kim was visiting Hong Kong Polytechnic University.

* Corresponding author. Tel.: +1 408 554 4667; fax: +1 408 554 2331.
E-mail addresses: y1kim@scu.edu (Y. Kim), hli4@scu.edu (H. Li), sli3@scu.edu (S. Li).

[1] Chen et al. (2001) warn that (p. 348): "Thus, when we speak of 'forecasting crashes' in the title of the paper, we are adopting a narrow and euphemistic definition of the word 'crashes,' associating it solely with the conditional skewness of the return distribution; we are not in the business of forecasting negative expected returns." Chen et al. point out that this definition follows Bates (1991), who relies on conditional skewness (inferred from the option markets in his case) to measure expectations of stock market crash.

http://dx.doi.org/10.1016/j.jbankfin.2014.02.013
0378-4266/© 2014 Elsevier B.V. All rights reserved.

It has been well documented that the distribution of stock returns exhibits negative skewness; that is, large negative stock returns, or stock price crashes, are more common than large positive stock price movements (e.g., Chen et al., 2001; Hong and Stein, 2003). Several studies have attempted to forecast firm-specific crash risk. One factor that emerges from the literature as a prominent predictor of stock price crash risk is the managerial tendency to withhold bad news from investors (e.g., Jin and Myers, 2006; Hutton et al., 2009). These studies contend that managers withhold bad news from investors due to career and compensation concerns, and when bad news accumulates and reaches a tipping point, all bad news comes out at once leading to a stock price crash. Supporting this view, empirical evidence suggests that opaque financial reporting, corporate tax avoidance, and executive equity incentives are positively associated with firm-specific crash risk, while accounting conservatism reduces such risk (Hutton et al., 2009; Kim et al., 2011a, 2011b; Kim and Zhang, forthcoming).

Prior studies present different views on the implications of CSR for managers' bad news hoarding behavior and transparency in corporate financial reporting. Kim et al. (2012) find that socially responsible firms also behave responsibly in financial reporting and exhibit less evidence of earnings management, suggesting that firms' commitment to higher ethical standards has a positive impact on accounting information quality. In a similar vein, Gelb and Strawser (2001) find that firms that undertake socially responsible activities provide more financial disclosure, consistent with the notion that companies consider increased disclosure as a form of socially responsible behavior in their overall implementation of CSR practices. If firms with better CSR cultures maintain the same high level of ethical standards in financial reporting, they are likely to be associated with a higher level of transparency and are less likely to conceal bad news from investors. Thus we would expect these firms to be associated with lower stock price crash risk.

On the other hand, there is a long-standing concern that managers may use CSR opportunistically to advance their careers or other personal agenda. Friedman (1970) is among the first to express concern that CSR represents a form of agency problem within the firm. Hemingway and Maclagan (2004) argue that one motivation for companies to adopt CSR is to cover up corporate misbehavior. Enron, for example, was widely respected as a model for the CSR movement and won several national awards for its environmental and community programs while at the same time engaging in massive accounting frauds that lead to its collapse in 2001 (Bradley, 2009). Consistent with this view, some studies find a positive relation between CSR and earnings management (Petrovits, 2006; Prior et al., 2008). If firms use CSR as a tool to disguise bad news and divert shareholder scrutiny, CSR would be associated with higher, not lower, stock price crash risk.

To test these two opposing views of the relation between CSR and stock price crash risk, we examine how firms' CSR performance is associated with future stock price crash risk. Our CSR performance measure is based on the social ratings data provided by the MSCI ESG database. Following prior studies, we measure firm-specific crash risk by the negative skewness of firm-specific weekly returns and the asymmetric volatility of negative and positive stock returns (e.g., Chen et al., 2001). Using a large sample of U.S. public firms from 1995 to 2009, we find a significantly negative association between firms' CSR performance and one-year-ahead stock price crash risk, suggesting that socially responsible firms have a lower future stock price crash risk. The results are robust after controlling for other predictors of future stock price crash risk identified in prior studies, including divergence of investor opinion, past returns, firm size, and accounting opaqueness. To mitigate concerns on endogeneity, we add additional control variables that may affect both CSR and crash risk, and employ the instrumental variables approach and the dynamic Generalized Method of Moments (GMM) method. Our results hold after addressing endogeneity using these tests.

In addition, we investigate whether the negative relation between CSR and future stock price crash risk is affected by the effectiveness of corporate governance and the level of institutional ownership. We find that when firms have less effective corporate governance (indicated by lower governance ratings by MSCI ESG, CEO being the chairman of the board, and lower shareholder rights based on the Gompers et al. (2003) governance index) or a lower level of long-term institutional ownership, the negative relation between CSR and future crash risk is significant. On the other hand, when firms have more effective corporate governance or a higher long-term institutional ownership, CSR does not appear to have a significant impact on crash risk. The results are consistent with the notion that the role of CSR in reducing stock price crash risk is particularly important when internal monitoring by the boards or external monitoring by institutional investors is weak. The results also address a potential concern that the negative relation between CSR and crash risk might reflect the effect of corporate governance; specifically, CSR firms may have more effective corporate governance, which in turn may limit bad news hoarding behavior and reduce stock price crash risk (Harjoto and Jo, 2011; Andreou et al., 2012). We find that the mitigating effect of CSR on crash risk is present only for firms with weak governance, suggesting that the negative relation between CSR and crash risk is not driven by CSR firms having more effective corporate governance. Overall, the evidence in our study supports the notion that managers operating in a strong CSR-oriented corporate culture show a lower tendency to conceal bad news, leading to lower stock price crash risk.

Our study makes several contributions. First, our study adds to the growing literature on CSR and its economic consequences. As discussed earlier, much work in this area has focused on the impact of CSR on firm performance and, to a lesser extent, firm risk. We depart from these studies and focus on the unique role of CSR in reducing crash risk, which captures asymmetry in risk or the third moment of stock return distribution. This role is distinct from the effect of CSR on stock return performance (first moment) or firm risk (second moment) documented in prior studies. Our results thus broaden our understanding of the implications of CSR on firms and investors. Our study also adds to the growing literature that examines CSR issues in the financial reporting contexts (e.g., Kim et al., 2012).

Second, our study extends prior research that attempts to forecast future stock price crash risk (e.g., Chen et al., 2001; Hong and Stein, 2003; Jin and Myers, 2006; Hutton et al., 2009; Kim et al., 2011a, 2011b; Kim and Zhang, forthcoming). Crash risk is an important characteristic of return distribution that is relevant to portfolio theories, asset-pricing, and option-pricing models. Sunder (2010) argues that crash risk cannot be mitigated through portfolio diversification, unlike the risk from symmetric volatilities. Harvey and Siddique (2000) suggest that conditional skewness is a priced factor. They find that investors command higher expected returns for stocks with more negative skewness as a reward for accepting this risk. Since crash risk captures asymmetry in risk, it is important for investment decisions and risk management. The stock market turbulence in recent years further highlights the importance of crash risk to investors. We extend prior studies by identifying a new factor that mitigates future stock price crash risk. Our study will be useful to firms and shareholders who want to manage tail risk in the stock market and to investors who want to incorporate crash risk in their portfolio and risk management decisions.

We discuss prior research in Section 2. Section 3 discusses the sample, variable measurements, and research design. Section 4 presents empirical results. Additional analysis is reported in Section 5. We conclude in Section 6.

Download English Version:

https://daneshyari.com/en/article/5088840

Download Persian Version:

https://daneshyari.com/article/5088840

Daneshyari.com