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Corporate fraud, systematic risk, and shareholder enrichment

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Abstract

The impact of the disclosure of alleged illegal corporate activities together with the possible motives for their use increasingly has become the subject of research by financial scholars. These studies primarily analyze the disclosure's effect on the market returns of the firm's equity. The consensus of these studies is that the initial disclosure of alleged illegal corporate activities results in significant negative abnormal returns to the existing shareholders. The size of these abnormal returns generally exceeds the actual fines, fees and penalties that the firms eventually experience. The impact of these disclosures on systematic risk and their possible implications for managerial behavior and corporate policy have suffered from relative neglect. The present research seeks to establish what, if any, impact the disclosure of alleged corporate fraud has on systematic risk. Using the data set provided by Karpoff and Lott (1993, The reputational penalty firms bear from committing corporate fraud. *J Law Econ*, 34, 757–802), this research tests whether securities experience any significant beta shifts upon the initial disclosure of alleged corporate fraud. Empirical tests find evidence consistent with the theory that agents engage in illegal activity in an attempt to enhance share price. The empirical results also provide additional insight into the question of why corporations engage in criminal activity. © 2000 Elsevier Science Inc. All rights reserved.

1. Introduction

The impact of the disclosure of alleged illegal corporate activities together with the possible motives for their use has increasingly become the subject of research by financial

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scholars. These studies primarily analyze the disclosure's effect on the market returns of the firm's equity. The consensus of these studies is that the initial disclosure of alleged illegal corporate activities results in significant negative abnormal returns to the existing shareholders. The size of these abnormal returns generally exceeds the actual fines, fees and penalties that the firms eventually experience. The impact of these disclosures on systematic risk and their possible implications for managerial behavior and corporate policy have suffered from relative neglect. The present research seeks to establish what, if any, impact the disclosure of alleged corporate fraud has on systematic risk. These results together with existing research provide useful implications for corporate policy.

2. Previous research on illegal corporate behavior

Cloninger (1981, 1990) tied the supply of criminal offenses function developed by Becker (1968) and subsequently tested by Ehrlich (1973) to the abandonment model of Robichek and Van Horne (1967). Cloninger developed a model that treats the supply of arson as a function of risk, return and opportunity costs. Previous research on arson sought to identify correlates of arson without attempting to specify any model. Empirical tests validate Cloninger's model both in the original sample and in the 1990 update incorporating Tobin's Q. Subsequently, Cloninger (1982) formulated the generalized hypothesis that agents may resort to illegal or unethical activity as additional means of enhancing share price. Even though efforts by agents to reduce risk by unethical means affects total risk, Cloninger has shown how these same efforts can specifically influence systematic risk. Thus, the rise in systematic risk upon the disclosure of alleged corporate criminal behavior may be interpreted as evidence of agents' desire to enhance share price.

Strahan, Smith, and Beedles (1983), using standard event study methodology, reported empirical results consistent with the share price enhancement motive, although they made no effort to attribute any motive to the illegal behavior. They found the presence of excess negative returns upon the first disclosure of alleged illegal corporate activity. Cloninger (1985a) further developed the theoretical basis for the use of illegal or unethical activities as a means of enhancing share price. Empirical support for this position is provided in Cloninger (1985b) through the case study of Hitachi's alleged corporate espionage against IBM. He found that upon the disclosure of the alleged theft of corporate secrets from IBM, Hitachi's stock price suffered significant declines while IBM's stock price experienced significant gains.

Lean, Ogur, and Rodgers (1985) found evidence that the disclosure of illegal activities by corporations adversely affects their profitability as measured by accounting returns. Cloninger, Skantz, and Strickland (1987) and Skantz, Cloninger, and Strickland (1990) provided further empirical support for the presence of excess negative (market) returns upon the disclosure of alleged price fixing. However, Oppenheimer and Stanley (1989) found only short-lived adverse affects on stockholder returns.

More recently, Karpoff and Lott (1993), in perhaps the most comprehensive study to date, examined the impact of corporate fraud on market returns of firms accused of fraudulent activity. Their research indicates that market returns suffer significant negative abnormal