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Corporate goodness and shareholder wealth ☆

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ABSTRACT

Using a unique data set, I study how stock markets react to positive and negative events concerned with a firm's corporate social responsibility (CSR). I show that investors respond strongly negatively to negative events and weakly negatively to positive events. I then show that investors do value “offsetting CSR,” that is positive CSR news concerning firms with a history of poor stakeholder relations. In contrast, investors respond negatively to positive CSR news which is more likely to result from agency problems. Finally, I provide evidence that CSR news with stronger legal and economic information content generates a more pronounced investor reaction.

1. Introduction

Economic theory suggests that companies should not internalize the negative externalities they exert on nonshareholding stakeholders such as communities, employees, or the environment (see, e.g., Pigou, 1920). Similarly, Friedman (1970) declared in his well known *New York Times* essay that the sole “social responsibility of business is to increase its profits.” Nevertheless, companies continue to channel significant resources to improving their relations with key stakeholders. Although putting an accurate figure on exactly how much large corporations spend on corporate social responsibility (CSR) initiatives is difficult, Hong, Kubik, and Scheinkman (2012) quote anecdotal evidence showing that annual CSR outlays of large U.S. corporations can and do end up in the hundreds of millions of dollars.

At the same time, an impressive body of research has been devoted to understanding whether and how investments in stakeholder relations impact a firm's profitability. Yet, much of this research has yielded inconclusive results: some studies find a positive relation, whereas others show a negative or no relation at all. Margolis, Elfenbein, and Walsh (2007) conduct a meta-analysis of many such empirical studies and conclude that the average relation between CSR and profitability is positive but small. In the present paper, I revisit the salient question of whether and how CSR

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matters for shareholder value by analyzing how investors react to positive and negative CSR events[1] in the short-run.

Some have argued that CSR is simply the manifestation of agency problems inside the firm (see Tirole, 2001; Bénabou and Tirole, 2010; Cheng, Hong, and Shue, 2013). According to this line of thought, CSR primarily benefits managers who, at the expense of shareholders, earn a good reputation among key stakeholders (e.g., local politicians, non-governmental organizations, or labor unions). Consequently, this agency perspective implies that positive news about CSR is bad news for shareholders. In contrast, an alternative perspective holds that companies engage with stakeholders for value-enhancing purposes. This view is sometimes referred to as "doing well by doing good," and Edmans (2011), Dimson, Karakas, and Li (2013), Derwall, Guenster, Bauer, and Koedijk (2005), Flammer (2013a), Servaes and Tamayo (2013), or Dowell, Hart, and Yeung (2000) provide examples of mechanisms through which CSR can enhance shareholder wealth. Under this value-enhancing view of CSR, managers engage with stakeholders simply because such projects are deemed to have positive net present value (NPV), and thus, positive news about CSR should be received favorably by shareholders. In this paper, I disentangle the short-run shareholder value implications of such agency and value-motivated CSR and provide evidence consistent with the view that when CSR is more likely to be driven by agency problems, it is detrimental to shareholder value. In contrast, shareholders tend to react positively to CSR news whenever it is more likely to be the result of the firm addressing problematic stakeholder relations by "offsetting" previous corporate social irresponsibility.[2]

The second contribution of this paper is to provide unique short-run event study evidence on the shareholder value implications of CSR data by Kinder, Lydenberg, and Domini Research and Analytics (KLD), a data provider whose measures are widely used in the financial economics literature (see, e.g., Statman and Glushkov, 2009; Gillan, Hartzell, Koch, and Starks, 2010; Hong and Kostovetsky, 2012; Hong, Kubik, and Scheinkman, 2012; Cheng, Hong, and Shue, 2013; Di Giuli and Kostovetsky, 2014; Albuquerque, Durnev, and Koskinen, 2013; Servaes and Tamayo, 2013; Deng, Kang, and Sin Low, 2013).[3] Thirdly, this paper provides thought-provoking and novel insights into the measurement and value implications of CSR by relying on textual analysis in the spirit of Tetlock (2007): I show, for instance, that investors react more strongly to CSR news containing strong economic and legal information content. Finally, the present paper is innovative because it explicitly addresses two methodological concerns that are pervasive in research concerned with CSR, namely, (i) measurement error and (ii) reverse causality.

Measurement error is an issue in research that examines the value implications of CSR because of the difficulty in accurately quantifying CSR given the qualitative nature of many CSR-related issues. In addition, no legally binding standards exist that require publicly listed companies to report coherently and, above all, truthfully on the extent to which they impose positive or negative externalities on their stakeholders. Although numerous private and non-private sector reporting and certification initiatives exist,[4] regulators such as the Securities and Exchange Commission (SEC) have only tentatively started to explore the notion of making the disclosure of environmental and social information a mandatory listing requirement for public firms.[5] Another reason why accurately measuring a firm's stakeholder relations remains difficult is that overall measures of the effects of corporate actions on the welfare of stakeholders do not exist. For example, corporate policies that benefit communities might turn out to be harmful to employees. Hence, coming up with a measure of overall stakeholder value is particularly challenging (see Tirole, 2001). Finally, outsiders (e.g., investors or regulators) cannot observe firm choices regarding CSR, implying that measures are likely to be biased, because firms have an incentive to greenwash, i.e., overstate their good and understate their bad deeds.

To overcome these measurement challenges, this paper focuses on outcomes of corporate behavior in the form of publicly observable events. I do so by constructing a unique

[1] The Internet appendix contains numerous examples of the kind of events analyzed in the paper.

[2] Kotchen and Moon (2012) show that firms do indeed respond to previous negative external events (e.g., lawsuits, controversies) by subsequently improving their stakeholder relations.

[3] Statman and Glushkov (2009) use KLD's measures to examine the performance of CSR-screened equity portfolios. Gillan, Hartzell, Koch, and Starks (2010) study the extent to which the measures are related to operating performance, efficiency, compensation practices, trading by institutional investors, and valuation. Hong and Kostovetsky (2012) show that Democrat-leaning fund managers tend to invest more socially responsibly. Hong, Kubik, and Scheinkman (2012) provide evidence that less financially constrained firms score higher on KLD's measures. Cheng, Hong, and Shue (2013) present evidence of an agency theoretic perspective on CSR in which managers engage in unproductive CSR as a way to enjoy private benefits. Di Giuli and Kostovetsky (2014) show that firms with Democratic-leaning chief executive officers (CEOs) are more socially responsible. Albuquerque, Durnev, and Koskinen (2013) show that CSR decreases systematic risk and increases firm value. Servaes and Tamayo (2013) show that KLD's measures are positively related to firm value for firms with high customer awareness. In the context of Mergers and Acquisitions, Deng, Kang, and Sin Low (2013) show that CSR creates value for acquiring firms' shareholders.

[4] See, for instance, the International Organization for Standardization (ISO) 14000 family regarding "Environmental Management" http://www.iso.org, the Global Reporting Initiative http://www.globalreporting.org/, the Sustainability Accounting Standards Board http://www.sasb.org/, the Carbon Disclosure Project http://www.cdproject.net, the International Integrated Reporting Council http://www.theiirc.org, the Climate Disclosure Standards Board http://www.cdsb.net, or social rating agencies such as MSCI http://www.msci.com/products/esg/stats or Thomson Reuters http://thomsonreuters.com/esg-research-data.

[5] See the SEC's Environmental, Social, and Governance Disclosure Work Plan at http://www.sec.gov/spotlight/invadvcomm/iacmeeting022210-minutes.pdf. Notable exceptions are the UK and the European Union. Since 2013, the London Stock Exchange requires UK incorporated firms listed on the Main Market to disclose their greenhouse gas emissions. See http://www.gov.uk/government/news/leading-businesses-to-disclose-greenhouse-gas-emissions. In a similar spirit, The European Parliament adopted on 15 April 2014 the EU Non-Financial Reporting Directive, which will require large companies and groups to disclose information on policies, risks, and results regarding environmental matters, social and employee-related aspects, respect for human rights, anti-corruption and bribery issues, and diversity on boards of directors. See http://europa.eu/rapid/press-release_STATEMENT-14-124_en.htm.