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Corporate social responsibility and CEO confidence

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ABSTRACT

This study examines the relationship between firm corporate social responsibility (CSR) and CEO confidence. Research shows that CSR has a hedging feature. Research also shows that more confident CEOs underestimate firm risks, which, in turn, leads them to undertake relatively less hedging. Consistent with this, we find that CEO confidence is negatively related to the level of CSR. Closer analysis shows that this effect is stronger in the institutional aspects of CSR, such as community and workforce diversity, rather than in the technical aspects of CSR, such as corporate governance and product quality. Our results are robust to different competing explanations, including narcissism, which refers in this context to CEOs who engage in CSR to attract attention and alternative proxies for CSR and CEO confidence.

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1. Introduction

Corporate social responsibility (CSR) is defined by McWilliams and Siegel (2001, p117) as involving “actions that appear to further some social good, beyond the interests of the firm and that which is required by law”. The range of CSR activities is broad. For instance, firms may develop products that are made of environmentally-friendly materials, work closely with community organizations, or donate to charities. This means that CSR activity can affect the firm and the broader society. With regard to CSR and firm value, the research is mixed. Early research (Friedman, 1970) argued that CSR is negative for shareholders, while more recently, others (Jiao, 2010; Edmans, 2011; Deng et al., 2013; Cheng et al., 2014; Flammer, 2015) found that it is positive for shareholder value. One particular way CSR might be positive for shareholders is as a hedging device (Boutin-Dufresne and Savaria, 2004; Heal, 2005; Lee and Faff, 2009; Goss and Roberts, 2011; Humphrey et al., 2012).

Recent research also shows that some personal traits of managers impact corporate policies, including hedging (Ben-David et al., 2013 and Deshmukh et al., 2013). This study focusses on the personal trait of confidence. Furthermore, overconfident managers systematically overestimate the probability of good outcomes and, correspondingly, underestimate the probability of bad outcomes resulting from their actions (Heaton, 2002). In particular, for the focus of this paper, managerial overconfidence has been shown to cause managers to undertake less hedging than optimal for stockholder value maximization (Malmendier et al., 2011 and Ben-David et al., 2013).[1] Consistent with these links between CSR and hedging and CEO confidence and hedging, this paper examines the relationship between CSR and CEO confidence.

In this paper, we document a significant negative relationship between CEO confidence and CSR activity. Specifically, the more confident the CEO, the less CSR activity undertaken by the firm. This relationship holds true after controlling for CEO characteristics of gender, age, and tenure and an array of firm, industry, and time variables. We also specifically test and reject an alternative hypothesis of narcissism (that is, those CEOs who seek attention, in this context by engaging in CSR), which proposes a positive relation between CEO confidence and CSR. More detailed analysis of different dimensions of CSR shows that the negative relationship between CEO confidence and CSR is found for institutional aspects of CSR, such as community and workforce diversity, but not for technical CSR, such as corporate governance and product quality. However, this result is weakened somewhat when we drill down into the individual aspects of CSR, and find that increasing levels of confidence is generally negatively related to positive aspects of CSR, but not related to negative aspects of CSR. In other words, more confident CEOs do less “positive” CSR, but do not do more or less “negative” CSR, relative to less confident CEOs.

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[1] Depending on the analysis undertaken, research may refer to overconfidence or level of confidence. The former uses a dichotomous variable and the latter a continuous variable. The current study considers both and will use the description most appropriate throughout the paper.

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We conduct tests to rule out other factors including gender, age and tenure, which might confound the interpretation of our results. Furthermore, CEO characteristics are commonly included in studies of CSR, although the results are not always consistent. We find that female CEOs, on average, score higher on CSR than male CEOs, their average confidence score is significantly lower than that of male CEOs. However, the gender of the CEO is not significant in explaining CSR in a multivariate setting. As well, the age of the CEO is negatively related to CSR, while tenure of the CEO is positively related to CSR, albeit at only the 10% level. All results are consistent after applying a barrage of robustness checks.

The paper is organized as follows: Section 2 discusses the literature and hypothesis development; Section 3 discusses the sample, variable selection, and descriptive analysis; Section 4 documents the research, design, and results; while Section 5 concludes the paper.

2. Literature review and hypothesis development

The key relationships in this study that we develop into the testable hypotheses are those between CSR and hedging, confidence and hedging, and confidence and CSR. That is, hedging is of potential value to the firm, and CSR is a form of hedging. As overconfident CEOs hedge less, we hypothesise that firms with overconfident CEOs will engage in less CSR. The literature to develop this argument is considered below.

2.1. CSR and hedging

Over recent years, the views by academics and practitioners on CSR have changed. Before the 1980s, CSR was treated as a burden on the firm, which benefitted various stakeholders but at the expense of stockholders (Friedman, 1970). From the 1980s, CSR grew in importance in firm strategy, which coincided with development of stakeholder theory of the firm (Freeman, 1984).

According to Godfrey et al., (2009), CSR is now used to signal to various stakeholders that the company is partially altruistic (other-considering) and not completely agonistic (self-considering). Generally, the managers of firms adopting CSR appear to consider the impact of their decisions upon social good and broad stakeholder interest in the expectation that this will flow back as “positive attribution or moral capital” (Godfrey et al., 2009, p428). In this sense, CSR is part of a firm’s risk management strategy; it can therefore be regarded as a hedging tool.

The broad area of firm risk management research is well developed, and a large amount of the research focusses on hedging. A number of strands exist in the literature. Firstly, there are those that look to develop a theory of hedging, such as Smith and Stulz (1985) who provide a theoretical framework for hedging as part of a firm’s overall financing policy, and Stulz (1996, p23–24) who argues that “the primary goal of risk management is to eliminate the probability of costly lower-tail outcomes–those that would cause financial distress or make a company unable to carry out its investment strategy”. Secondly, there is a large body of empirical work that investigates the determinants of firms that hedge, using survey data, including Nance et al. 1993 and Tufano 1996.

More recent empirical work focusses on the impact of hedging on firm value. For example, Allayannis and Weston (2001), Carter et al. (2006), Adam and Fernando (2006), Bartram et al. (2011), Campello et al. (2011) and Perez-Gonzalez and Yun (2013) all report that hedging increases firm value. In contrast, Jin and Jorion (2006) found no relation between hedging and firm value in oil and gas firms.

In terms of CSR as a hedge, CSR is clearly not as explicit as using a derivative contract. It is more subtle, and is about creating goodwill. For example, if a firm experiences an event that has a negative impact on its operations such as the impact on customers affected by changed trading hours or employees by changed work conditions, CSR mitigates the negative impact of the event. It does this by creating moral capital. Such moral capital helps stockholders attribute the negative event to what Godfrey et al. (2009, p428) call “managerial maladroitness rather than malevolence”, which accordingly, reduces the punishment to firms facing these negative events. Thus, CSR is a way of hedging some of the risks facing the firm (Peloza, 2006; Godfrey et al., 2009 and Minor and Morgan, 2011). Empirical evidence confirms this hedging feature of CSR. Godfrey et al. (2009) find that when firms are facing negative law suits in the US, those with higher CSR suffer less firm value reduction than those with lower CSR. Additional evidence supporting CSR’s hedging effects is provided by Minor and Morgan (2011), who find that firms with higher levels of CSR investment suffer relatively less firm value reduction in cases where a product recall is required due to a product defect. In addition, Boutin-Dufresne and Savaria (2004), Lee and Faff (2009), and Humphrey et al. (2012) find evidence that CSR is positively related to lower firm idiosyncratic risk.

2.2. Confidence and hedging

The link between CEO confidence and hedging stems from the assertion that overconfident CEOs overestimate their ability to obtain precise information about cash flows generated from prospective projects. In other words, they overestimate their own accuracy. This leads overconfident CEOs to underestimate the variation in cash flows generated from these projects. Overconfident CEOs understate the risks of projects (Ben-David et al., 2013 and Deshmukh et al., 2013), and because overconfident CEOs perceive their firms to be relatively less risky, they are less likely to hedge their firm’s operations. This is borne out in the empirical literature. Marshall et al. (2012), for example, find overconfident managers in the UK are less likely to hedge foreign exchange exposure, and Adam et al. (2012), using a sample of North American gold mining firms, document that overconfident CEOs undertake less hedging (are more risky).[2]

Although a range of methods has been used to measure overconfidence (Hill et al., 2014), the most common were developed using managerial stock options (Malmendier and Tate, 2005a and 2005b). Malmendier and Tate (2005a and 2005b) proxy for a CEO’s overconfidence in two ways using a dichotomous classification. The first is based on beliefs revealed from managerial stock option exercise behaviour, while the second is based on outsiders’ perception, obtained from analyses of media and how the CEO is portrayed. Malmendier and Tate then use these overconfidence measurements to empirically examine how CEO overconfidence affects a firm’s investment decisions. They find that the investments and cash sensitivity are stronger among firms with overconfident CEOs, especially equity-dependent firms. The results are consistent with both proxies for overconfidence.

In this paper, we follow Malmendier and Tate’s (2005a and 2005b) method of using managerial stock option exercise behaviour to determine confidence levels. However, rather than having a dichotomous variable for overconfidence/not overconfidence, we initially follow Banerjee et al. (2015a and 2015b), amongst oth-

[2] The relationship between overconfidence and firm value is more complex than between overconfidence and hedging. There is evidence that overconfident CEOs tend to over-invest and waste money on negative NPV projects (Gervais et al., 2011; Campbell et al., 2011 and Kim, 2013). However, the level of overconfidence seems important. For example, Goel and Thakor (2008) show that moderate levels of CEO overconfidence benefit the firm while extreme levels are detrimental. Generally, it is not clear if overconfident CEOs have a positive or negative effect on firm value (Banerjee et al., 2015a).

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