Corporate Social Responsibility, Firm Value and External Corporate Governance

Bonnie Buchanan
Howard Bosanko Professor of Economics and Finance
Department of Finance
Albers School of Business and Economics
Seattle University
901 12th Avenue
P.O. Box 222000
Seattle. WA. 98122
Ph: (206) 296-5977
Fax: (206) 296-2486
Email: buchanab@seattleu.edu

Cathy (Xuying) Cao, CFA
Department of Finance
Albers School of Business and Economics
Seattle University
901 12th Avenue
P.O. Box 222000
Seattle. WA. 98122
Ph: (206) 296-5712
Fax: (206) 296-2486
Email: caoc@seattleu.edu

Ben (Chongyang) Chen, CFA
Department of Finance
School of Business
Pacific Lutheran University
Seattle. WA. 98122
Email: chencb@plu.edu

Keywords: Environmental, social, and governance; Corporate social responsibility; Financial crisis; Institutional investors; Shareholder value maximization; Stakeholder theory.

JEL classification: D22; G34; M14

Extended Abstract

Extended Abstract

"*Being socially responsible is both a moral and business imperative. Any company that ignores its obligation to be a good corporate citizen risks undermining its reputation and jeopardizing its profitability over the long run.*"[1]

-- Jay Hooley, CEO and Chairman, State Street Corporation
October 24, 2014

"*Corporate social responsibility is an ill-defined- and incompletely defined concept*"

Baron (2001)

Does corporate social responsibility (CSR) affect firm value? As the global economy becomes increasingly more financialized, greater attention is being paid to corporate social responsibility (hereafter known as CSR) issues. This has been by regulators, governments, investors and institutions. The number of socially responsible (SR) investors and their amount of money invested has increased markedly over the last decades. US-domiciled assets under management using SRI strategies expanded from $3.74 trillion in 2012 to $6.57 trillion in 2014 – a 76 percent increase (US SIF, 2014)[2]. During the same period, more institutional and asset managers have committed to the Principles for Responsible Investment Network (PRI), a global framework that takes ESG considerations into account. Blackrock and Goldman Sachs have launched Social Responsible Funds (SRF). The number of mutual funds and ETFs catering for SRI had increased as well. Approximately 650 academic institutions in 85 countries have become signatories to the PRME Network. Many U.S. university endowment funds have established Socially Responsible Investment Review Committees to review their endowment policies on socially responsible investment and implementation issues. Over 400 US colleges and universities have decided to adopt more ethical approaches to their endowment funds. In the

[1] "Companies have no choice but to be good corporate citizens", Wall Street Journal. October 24, 2014.
[2] This now accounts for more than one out of every six dollars under professional management in the United States.

last few years, as part of SRI, many US academic institutions have announced divestment of holdings in oil and gas companies[3]. Various investment companies have divested funds from the top 15 carbon coal companies (known as the "Filthy 15") in the US[4]. ESG principles are now even the subject of interest for MOOCs as well. Crowdfunding has also become a tool for ESG investors.

The evolution and growth of SRI investing with US markets may be attributed to: money managers and portfolio managers responding to client demand; the growth of PRI; the aftermath of the 2012 Sandy Hook elementary school shooting (managers have incorporated criteria relating to military and weapons production); climate change. The SEC requires companies to disclose political spending. The World Federation of Exchanges has advocated for more responsible investing practices, more corporate governance controls, and a greater emphasis on corporate social responsibility (Sustainable Stock Exchanges Initiative, 2015).

There's been a surge in shareholders urging companies to be a good "citizen", such as doing a better job about protecting forests, human rights, and disclosing political spending. A 2013 triennial UNGC Survey reported that 93 percent of respondents regarded ESG issues essential to the success of their business. Yet 37 percent said a lack of a clear link between ESG and firm value deterred them from taking action. Similarly, a CFA Institute survey in 2015 reported that 73 percent of respondents considered ESG issues important, with governance being the most common. And when asked what if anything would cause them to begin considering ESG issues in their investment analysis, 48 percent stated they would if there was a proven link between ESG and firm financial performance.

---

[3] Campus Activists Unite in Call for Divestments at Colleges, Wall Street Journal, December 29, 2015.
[4] There is also the Carbon 200 Tracker.

The findings are mixed with regard to the effect of corporate social responsibility (CSR) on the firm value or financial performance. For example, Guenster et al. (2010) provide evidence suggesting that corporate environmental performance is positively related to firm value. Similarly, Jiao (2010) shows that corporate social performance is associated with a positive valuation effect. In contrast, Brammer et al. (2006) find that firms with higher social performance scores realize lower returns. However, Hamilton et al. (1993) find that the excess returns of socially responsible mutual funds do not differ statistically from those of conventional mutual funds, and Nelling and Webb (2009) find no evidence that CSR activities affect financial performance. The review paper by Renneboog et al. (2008) concludes that whether CSR is priced by capital markets remains an open question.

A major obstacle limiting empirical progress on the topic is the difficulty to deal with the endogenous nature of firm performance and CSR activities. We propose that the conflicting findings are due to the implicit assumption that the firm's decision to take corporate social responsibility is exogenous and random. In fact, as shown in Hong, Kubik and Scheinkman (2012), firms do good only when they do well in the sense of having financially slack resources. Specifically, a profitable firm is more likely to have resources to implement a corporate social responsibility program; meanwhile, corporate social responsibility program can increase a firm's product awareness and investor recognition, which can affect firm value and the cost of equity. Failing to account for endogenous choice of taking CSR activities can contaminate the pricing effect with the selection effect of CSR activities, and thus lead to inconsistent empirical estimation.

This study offers a novel empirical approach that allows us to overcome this challenge and shed considerable light on the impact of CSR activities on the firm performance.

Specifically, we employ Heckman self-selection estimation approach to control for the endogenous choice of taking CSR activities. In addition to its empirical importance, our method is motivated by theoretical literature on corporate social responsibility**.** Previous studies underscore the endogenous nature of CSR activities and predict that financial performance is an important factor in determining the choice of taking CSR activities. For example, Hong, Kubik and Scheinkman (2012) model a firm's optimal choices of capital and goodness subject to financial constraints. They predict that less financially constrained firms spend more on goodness.

To explore the robustness of our findings, we apply an alternative empirical approach. Specifically, we use the 2008 financial crisis as a source of unexpected exogenous shock to financial environment. The recent financial crisis, due to its severity represents an ideal natural experiment to investigate the effect of CSR activities on firm value during a crisis period. The 2008 financial crisis was an unexpected exogenous event (from an individual firm's perspective) whose duration was unknown at the time of its onset. During the financial crisis, firms face limited resources and uncertainty about the duration of the financial liquidity scarcity, which magnifies both the benefits and costs of maintaining high CSR activities. We compare firm's CSR activities before and after 2008 financial crisis. We ask whether firms with improvements in CSR activities experience higher or lower firm value afterwards.

We find that although CSR activity is positively related to firm value (Tobin's Q) before financial crisis, the firm values of the Responsible Companies decrease more than those of other firms during financial crisis. In addition, the Responsible Companies with different level of influential institutional ownership perform differently. We find that firm value of the Responsible Companies with high influential ownership decreases more than that of other firms with same level of ownership; while among firms with low influential ownership, the magnitude of decrease in firm value of the Responsible Companies are not significantly different from that of other firms. The findings are consistent with the notion that during financial crisis, influential institutions tend to actively engage in the Responsible Companies' management, which can decrease the level of employee perceived managerial integrity and lead to lower firm performance and firm value.

Finally, we find that all firms experience improvements in their firm value after financial crisis. However, our evidence suggests that firm value of the Responsible Companies do not recover as quickly as that of other firms after the crisis, regardless of their financial flexibility and influential institutional ownership.

Our paper complements previous literature that studies the relation between CSR and firm value. The key contribution of our paper is to show that the impact of CSR on firm value changes over time. The ambiguous results documented in prior literature can be due to the different sample periods used in the tests. Our test design not only allows us to study the effect of CSR on firm value at a particular point in time, but also helps us examine the variation in such effect over economic cycle. We find that firms with high CSR experience larger decrease in their firm value than other comparable firms when financial crisis happens. Moreover, we show that CSR does not have significant impact on the recovery of firm value right after financial crisis.

This paper also contributes to the growing literature on Socially Responsible Investment (SRI) and investment performance. The prior studies document mixed empirical evidence on investment performance of SRI (see Renneboog, Horst, and Zhang (2008) for literature review). Our study not only provides an investment recommendation to a SRI investor by showing how firms with active CSR engagement perform around an economic downturn, but also identifies a crucial factor that affects the value-creation of CSR: external corporate governance. Our findings show that high CSR alone does not create firm value during financial crises; only by combining high CSR with low external corporate governance can these CSR firms have higher firm value than otherwise.