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| 2021 Winning Paper

Corporate Misconduct and Market Reactions: The Moderating Role of Moral, Technical, and Leadership Capital

Runner-up Prize paper - 2021 Chinese Studies Research Brief Prize

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Lu Ye is a third-year doctoral student who majors in management. Her research interests lie in corporate governance and corporate misconduct with focuses on board of directors, top management team, CSR, and impression management. Lu Ye examines how corporate governance practices affect various corporate outcomes and how corporate misconduct in turn influences governance systems.

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With the increase of corporate misconduct, its origin, framing, and consequence have received considerable attention among academic literature and practitioners. Corporate misconduct, which refers to corporate behaviours that deviate from social norms, can cost stakeholders significant resources (Daboub et al., 1995). Negative stock market reactions have been recognized among many studies on the consequences of corporate misconduct (Paruchuri & Misangyi, 2015). However, this line of research neglects the diffused reactions in responses to similar corporate misconduct such as "violations (that) are largely outside the control of firms" (Etter et al., 2019: 5). To explain this variation, extant models are "limited in their ability" because investors are often assumed to make judgments in an objectively correct way and stock prices reflect objective firm values (Baker et al., 2019: 319). Urbig et al., (2013) suggested that investor reactions to events depend on not only the availability of information but also how information is interpreted. From a cognitive view, investors are believed to use cognitive templates to determine the punishment for firms (Godfrey, 2005). Further, Barnett (2014) asserted that stakeholders evaluate both the characteristics of the event and the firm when facing misconduct.

As such, we propose that investors' cognitive template may explain the variation of market reactions. Specifically, as severity indicates the magnitude of misconduct and investors' value incongruence (Devers et al., 2009), severity might relate to the stakeholders' generalized evaluation of inappropriateness and anger (Cooper et al., 2007), and increase the likelihood of negative and aggressive market reactions. Therefore, we posit that cognitive templates are primarily decided by the severity of corporate misconduct (i.e., event-level evaluation), which then interacts with the evaluation of firm characters to jointly shape investor reactions.

Our conceptual framework builds on signalling theory (Spence, 2002), which emphasizes information asymmetry between two parties. Signals can increase or reduce information asymmetry by communicating unobservable quality and intent to various stakeholders (Zhang & Wiersema, 2009). We consider misconduct as a value incongruence signal that negatively influences investors' cognitive template and widens information asymmetry when evaluating the firm. The stronger signal (i.e., higher severity), the more intense public scrutiny and reactions.

Moreover, signalling scholars called for research to investigate more complex formulations and understand "how receivers interpret sequencing and signal patterns" (Connelly et al., 2011: 60), yet extant research often modelled signals in isolation (Drover et al., 2018). This study, thus, aims to extend the framework by exploring the signalling roles that firm characters play in interacting with perceived severity and mitigating intensive market reactions. To alleviate stigmatization of corporate misconduct, a prior reputation is crucial because a positive reputation demonstrates good quality and intent of the firm, and then acts as a "filter" to decrease stakeholders' perceptions of misconduct severity (Godfrey et al., 2009). According to signalling theory, reputation is formed based on multiple signals about firms' relative structural positions within industry or fields, including institutional, strategy, and market signals (Fombrun & Shanley, 1990). This study identifies three different dimensions of firm characters as signals to shape investors' evaluation of firm reputation (e.g., Altura, 2020). First, as audiences judge how well firms respond to their social concerns, the institutional signal can influence firm reputation through showing conformity to social norms (Fombrun & Shanley, 1990). We identify moral capital as the institutional signal because it is often generated from a firm's social responsiveness to social concerns (e.g., Flammer, 2013). Second, audiences also evaluate firms through managers' strategies, which signal the firm's prospects. Given that technical investment demonstrates the firm's resource allocation, we recognized it as a strategy signal to indicate a firm's innovation and long-term oriented strategic postures. Third, market signals that convey information about a firm's activities and performances are needed to construct its reputation (Fombrun & Shanley, 1990). We use leadership capital as a market signal to indicate the firm's relative status in the market, which is the result of the firm's previous actions. Taken together, good firm characters send positive signals to the market and boost perceptions of its reputation, which decreases perceived severity and alleviates market reactions.

The sample of our study is formed from Chinese listed companies that have been involved in financial misconduct over the period from 2009 to 2019. The final sample consists of 344 financial misconduct events, which were conducted by 302 Chinese publicly listed firms. Following extant research (e.g., Sun et al.,2016), we collected data from China Stock Market and Accounting Research (CSMAR), Rankins CSR Ratings (RKS), and National Economic Research Institute (NERI). First, we employed the event study methodology as described in Flammer (2013) to generate average cumulative abnormal return (CAR) in a three-day interval (-1, 1). Second, based on the CAR results (i.e., market reactions), OLS regression analysis is used to test hypotheses (e.g., Rhee & Fiss, 2014). To ensure robustness, we use alternative operationalization of independent variable, other event windows, and alternative asset-pricing models.

Descriptive statistics are presented in Table 1. In Table 2, we find strong support for the negative effect of severity on market reactions and moderating effects of moral and technical capital (see Figure 1). While the effect of leadership capital is insignificant, the overall findings provide insights and make contributions. The overarching assumption of prior research is that investors make objectively correct judgments, which is limited in explaining the difference of market reactions (Busenbark et al., 2019). We challenge the investors' rational expectation assumption by underlining the cognitive templates of investors, which shape their varied interpretations and reactions (Godfrey, 2005). From a cognitive view, we theorize and find that investors' cognitive template is influenced by both the severity of the misconduct and firm's characters. This suggests that investors' cognitive templates add complexities to extant models of market reactions, providing a valuable lens through which to study outcomes of misconduct. Additionally, building on signalling theory, we examine the negative and positive signalling roles of severity and a firm's characters in affecting investor reactions. Signalling research noted that a signal is often studied in isolation, while how audiences interpret multiple and inconsistent signals remains underdeveloped (Connelly et al., 2011). This study recognizes the interplay between an event signal and a firm's character signals, demonstrating how positive signals provide quality and good intent information to construct investors' reputation perceptions and interact with the following negative signal. While not all moderating effects are significant, the overall positive effect of reputation signals illustrates how investors interpret sequential and incongruent signals. Hence, we advance the understanding of investors' cognitive processing of competing signals and contribute to signalling theory. Lastly, we enhance reputation research by exploring the situations when reputation can be a benefit or a burden following misconduct (Bundy et al., 2017). This study uses three dimensions of firm characters to capture the construct of reputation, and finds that moral and technical reputation are effective, but leadership reputation does not positively bias investors' interpretation of misconduct. The findings develop a nuanced understanding of reputation and suggest that different dimensions of reputation may explain prior inclusive findings.

Tables & Figure

[Access from Here]

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