DOES CORPORATE SOCIAL IRRESPONSIBILITY REPUTATION AFFECT ACCOUNTING-RELATED LIQUIDITY RISK?

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ABSTRACT

This study examines whether a firm's CSIR reputation affects accounting-related liquidity risk in the stock market. Following Liu (2006)'s liquidity-augmented capital asset pricing model (LCAPM) and Chen et al. (2007) accounting-related liquidity risk, we find that a firm's CSIR coverage is positively associated with accounting-related liquidity risk, indicating that investors expect higher compensation for liquidity risks that they bear when they invest in firms that have worsened CSIR reputation. The sensitivity tests show evidence that is consistent with the notion that high-risk firms tend to distribute more information to investors by engaging in CSR activities to retain a good reputation, decreasing information asymmetry between insiders and outsiders. This study provides a better understanding of the link between CSR performance and information asymmetry.

Keywords: CSIR reputation, liquidity risk, accounting quality, information asymmetry

1. INTRODUCTION

Investors have imperfect information about the firms they invest in (Greenwald and Stiglitz, 1990). This makes the role of external information providers such as RepRisk AG more salient as they provide new information about the firm's environmental, social, and governance (ESG) performance to investors (Ramchander et al., 2012). Media coverage of ESG issues is considered *Corporate Social Irresponsibility* (CSIR) information. CSIR conveys illegitimacy, the "set of corporate actions that negatively affects an identifiable social stakeholder's legitimate claims" (Strike et al., 2006). A firm's CSIR activities signal problems to stakeholders that negatively affect a firm's reputation (Groening & Kanuri, 2013), decrease positive media coverage (Zavyalova et al., 2012), and reduce firm legitimacy (Doh et al., 2010). For example, firms with greater levels of CSIR have lower earnings persistence (Hsu et al., 2019), and exacerbates risk to a greater degree than corporate social responsibility (CSR) mitigates it (Oikonomou et al., 2014). Moreover, stock markets react negatively to news of CSIR (Groening & Kanuri, 2018).

In this study, we examine whether a firm's CSIR reputation affects accounting-related liquidity risk in the stock market. The answers to this question are important for several reasons. First, media coverage of ESG issues demonstrates the risk-generating effect of CSIR coverage through potential of stakeholder sanctions which may result in lower future earnings (Kolbel et al., 2017). Investors may perceive these firms as higher-risk firms as firms may tend to distort accounting information quality and eventually affect accounting-associated liquidity risk. Second, due to its higher level of diagnosticity and salience, CSIR is more relevant to investors than CSR (e.g., Dhaliwal et al., 2014). A firm's CSIR reputation affects the degree to which stakeholders view the firm as a good or bad actor (Lin-Hi & Blumberg, 2018). A poor CSIR reputation indicates concerns with a firm's long-term viability (Bozzolan et al., 2015), signaling issues with future earnings and firm value (Groening et al., 2016). CSIR reputation may cause investors to be concerned about the riskiness of the firm, and thus their ability to forecast a firm's earnings (Glossner, 2017). In other words, the reduction in information asymmetry around CSIR can unveil greater levels of information asymmetry around other aspects of the firm.