research insights

How to Manage Your Company's Reputation Through a Crisis and Come Out on Top

On March 18, 2006, *The Wall Street Journal* unleashed a tsunami, reporting that several firms had falsified the dates they had awarded stock options to employees. This "stock options backdating scandal" ultimately cost Apple and the other firms involved an average of 3.6 percent of their share price. But some firms suffered steeper losses than others. One reason why some firms fared better might be their reputations. But how does a reputation for social responsibility reduce the negative stock market impact of a scandal? How should firms communicate their involvement in a scandal? It is better to disclose early or wait until the firm and shareholders have a better handle on the situation?

Jay J. Janney (University of Dayton) and Steve Gove (Virginia Tech) answered these questions by studying market reactions to firm disclosures of involvement in the U.S. stock options backdating scandal. Using a sample of 108 firms, they compared predicted stock returns before the firm's announcement to the actual returns after the announcement.

The study found that although firms involved in the scandal, on average, suffered significant stock price declines, CSR created a layer of protection. Firms with strong reputations for social responsibility experienced average price drops of 1.3 percent less than other firms.

However, this buffering effect is contingent on the basis for the firm's reputation. While CSR initiatives in areas like philanthropy and community involvement afford protection, a reputation-based for good governance actually worsens the negative impact (an additional 1.3 percent decline). Investors see this type of behaviour as hypocrisy.

The research conducted on the backdating scandal also uncovered two crucial lessons on how to best manage corporate scandals:

Disclose voluntarily. Waiting for a regulatory body or the media to break the news makes it look like your firm is attempting to hide. Voluntary disclosure allows you to apply your own framing, giving your company more control over investor perception of the scandal. For instance, investors can perceive disclosure as a signal of the company's willingness to cooperate with authorities, further alleviating concerns about the depth of the problems at hand. Firms that voluntarily announced experienced declines of -2.67 percent compared to -3.46 percent for firms exposed by others.

> "Firms with strong reputations for social responsibility experienced average price drops of 1.3 percent less than firms without such reputations."

But don't disclose too early. Delay disclosure until a few other firms reveal information about the same scandal. Over time, as more information is revealed, the firm and shareholders better understand the scope of the situation. Delaying disclosure also allows the firm to frame the announcement as a resolution announcement, suggesting management has already scoped the problem and has begun working to address it. Firms that waiting to disclose saw stock price declines of less than half of those firms that disclosed early (-1.81 versus -4.41 percent).

This study tested market reactions to the 2008 backdating scandal. It specifically looked at firms trading on one of the three major North American stock exchanges (NYSE, American and NASDAQ). To better understand investor reactions to scandal announcements and the ability of CSR to protect firms against declines in stock value, future research can investigate other scandals, different stock exchanges and longer timeframes.

Source: Janney, Jay and Gove, Steve (2011). Reputation and Corporate Social Responsibility Aberrations, Trends, and Hypocrisy: Reactions to Firm Choices in the Stock Option Backdating Scandal. *Journal of Management Studies* 48:7.
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April 2012