Effects Of Explanations Communicated In Announcements Of Alleged Labor Abuses On Valuation Of A Firm's Stock

By: **Joseph Patrick Daly, Richard W. Pouter,** and **Chris R. McNeil**

Abstract

The purpose of this paper is to gauge the impact of the following on the share price of a firm that has allegedly committed labor abuses: the allegation itself, explanations (justifications and excuses) offered by the company spokesperson, and denials of responsibility for the alleged abuse. The study uses archival data and an event study methodology. Labor abuse allegations have a negative impact on the firm's share price. Allegations that are accompanied by an explanation (a justification or excuse) have a less negative impact than those that are not accompanied by an explanation. Denials of responsibility have a negative influence on the share price. If managers want to avoid a negative hit on the share price from an allegation of wrongdoing, they should provide an explanation (a justification or excuse) and avoid the use of denials.

Daly, J. P., Pouder, R. W., & McNeil, C. R. (2017). Effects of explanations communicated in announcements of alleged labor abuses on valuation of a firm's stock. Corporate Communications, 22(1), 93-112. Retrieved from https://login.proxy006.nclive.org/login?url=https://search.proquest.com/docview/1857567608?accountid=8337. Publisher version of record available at: https://www.emeraldinsight.com/doi/full/10.1108/CCIJ-11-2015-0070

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Purpose

The purpose of this paper is to gauge the impact of the following on the share price of a firm that has allegedly committed labor abuses: the allegation itself, explanations (justifications and excuses) offered by the company spokesperson, and denials of responsibility for the alleged abuse.

Design/methodology/approach

The study uses archival data and an event study methodology.

Findings

Labor abuse allegations have a negative impact on the firm's share price. Allegations that are accompanied by an explanation (a justification or excuse) have a less negative impact than those that are not accompanied by an explanation. Denials of responsibility have a negative influence on the share price.

Practical implications

If managers want to avoid a negative hit on the share price from an allegation of wrongdoing, they should provide an explanation (a justification or excuse) and avoid the use of denials.

Originality/value

Prior research has shown a negative impact from several types of labor abuse. This study extends prior research by showing a negative impact for all forms of labor abuse as a general category; it also extends findings from lab research on the impact of explanations on fairness judgments to a new context and a new dependent variable (the financial performance of the firm), which is on an organizational scale. It adds to the extreme paucity of empirical findings relative to the impact

of denials and also adds to a small but growing literature on fairness judgments by third parties and their consequences.

1.

Introduction

Corporations often attempt to influence investor interpretations of their actions through how they communicate those actions (Westphal and Zajac, 1998). Organizations may selectively frame their use of language to convey preferred meanings to shareholders (Benford and Snow, 2000). As Rhee and Fiss (2014) note, selectively framing communications to influence stakeholders is especially important when an organization's actions are controversial, where attempts are often made to justify such actions in the minds of investors. Investors may interpret information in announcements generally associated with negative performance implications in ways that mitigate those negative reactions (Muller and Kräussl, 2011). Rhee and Fiss (2014) observed this in their study of explanations offered by firms adopting a poison pill. Their findings showed that how firms framed language in announced adoption of poison pills affected the stock market reaction.

As noted by Sutton and Galunic (1996), leaders use protective verbal tactics to persuade shareholders to continue their support when faced with information that threatens their organizations. Skarlicki and Kulik (2005) claim that there is evidence that acts of perceived unfairness on the part of managers can negatively impact corporate financial performance, however the evidence that Skarlicki and Kulik cite in support of that assertion is anecdotal. The importance of information in these statements comes into focus in a study of discrimination lawsuits by James and Wooten (2006), who point out that:

[I]t is not necessarily the lawsuit itself that is most harmful to an organization. Rather, it is the firm's response to the lawsuit that can cause the most damage. When a firm's handling of a crisis is perceived as fair for the organization, its members, and those harmed in the crisis, the consequences of the crisis should be less severe than when a firm is believed to have been dishonest, self-serving, or incompetent in resolving a problem.

In our study, we are concerned with the effect that the presence or absence of explanations and denials in news announcements of alleged labor abuses by company spokespeople of publicly traded firms will have on the investment decisions of investors, namely, whether to buy, hold, or sell the firm's stock. In explaining those phenomena we invoke several theoretical frameworks, including organizational justice, corporate social irresponsibility (CSI) (Lange and Washburn, 2012; Lin-Hi and Muller, 2013), attribution theory, situational crisis communication theory (SCCT) (Coombs, 2007), and image restoration theory (Benoit, 1995). We define abusive labor practices as acts of discrimination, harassment, and/or unfair compensation.

One of the theoretical contexts we are considering here is Greenberg's (1987) "organizational justice," consisting of fairness judgments made by members of an organization concerning actions made and communicated by decision makers. There have been a great many studies of fairness judgments made by employees, about their own treatment at the hands of managers. In addition to that, some theory has emerged recently on the subject of fairness judgments made by third parties (O'Reilly and Aquino, 2011; Skarlicki and Kulik, 2005). O'Reilly and Aquino (2011) define third parties as, "those individuals who are neither the direct target of an injustice nor the perpetrator of the act" (p. 256). That is, third parties make judgments, including fairness judgments, about the alleged harm-doer's treatment of the victim and, in the case of investors, collectively have the power either to reinforce or to punish the harm-doer's behavior. Among the examples given of third parties by O'Reilly and Aquino (2011) and Skarlicki and Kulik (2005) are investors, which is our focus. To our knowledge, no other study beyond the present one has looked at investors' judgments as third parties.

Another set of the theoretical contexts we are invoking here is the literature in communications on crisis management, though our focus is not on full-blown crises but on potential crises. Our emphasis is on crisis prevention, which Coombs (2009) asserts is an understudied phenomenon. So our focus is on potential harm to the organization's reputation and its financial performance brought about by issues (Coombs and Holladay, 2012) or problems (Coombs, 2002) that have the capacity to be transformed into legal crises such as class action lawsuits.

To measure the effects of third party assessments of alleged labor abuses on a firm's financial performance, we used the event study method. In event studies the "events" are unexpected announcements made by a firm. Event studies have spawned a rich body of research that examines how investors assess the financial impact of firm-specific events (Lubatkin and Shrieves, 1986). When the information contained in an announcement signals to investors a positive (negative) change in expected future cash flows, there will be a positive (negative) effect on share price (Brown and Warner, 1985). A firm's stock price captures all expected future cash flows, discounted for risk and time, that are expected to accrue to the shareholder (Rappaport, 1997). Stock price is often used as a proxy for a firm's financial performance in that it reflects the economic value enjoyed by a shareholder owning shares of a firm, i.e., shareholder value. The event study method is relevant to our study because it allows us to test what effect unexpected announcements of alleged abusive labor practices might have on how investors as third parties evaluate the impact of these practices on shareholder value. Consistent with our focus in this paper, some event studies have examined firm-specific events involving labor-friendly and -unfriendly corporate practices (e.g. Arthur, 2003; Hannon and Milkovich, 1996; Hersch, 1991; Ursel and Armstrong-Stassen, 2006). To our knowledge, ours is one of the first studies to examine the dynamics of third party judgments in a real setting. We believe it is the first to consider the effects of explanations and denials on the financial performance of a company.

2.

Hypotheses

2.1

Main effect of alleged labor abuses on stock returns

The Anglo-American model of corporate governance is characterized by dispersed ownership and emphasizes short-term returns, well-protected shareholder rights, arms-length creditor financing, and active markets for organizational control (Aguilera, 2005). In their theory of the conditions that spawn corporate social responsibility (CSR), Aguilera *et al.* (2007) argue that, even within the Anglo-American model, investors are motivated to push for greater CSR because, if a firm's reputation is damaged, that damage has implications for that firm's competitiveness. In addition, a meta-analysis by Orlitzky *et al.* (2003) clearly shows that CSR is associated with enhanced financial performance. In particular, institutional investors typically have large investments in a corporation and thus cannot move in and out of ownership as readily as individual investors can (Aguilera *et al.* , 2007). Therefore, institutional investors are more apt to try to actively influence the firm's level of CSR as opposed to selling their holdings in order to avoid a short-term loss. Additional motives for investors include pre-empting negative publicity, avoiding disinvestment by others, and not incurring penalties associated with non-compliance. Protecting the legitimacy of the firm can be seen as a motive for investors to encourage a firm to engage in CSR-enhancing activities (Aguilera *et al.* , 2007) and, by extension, to avoid activities that can be labeled as socially irresponsible. While the emphasis in CSR research is on "doing good," CSI (Lange and Washburn, 2012) focuses on "avoiding doing bad."

Attribution theory, which originated in research on person perception, has been extended to perceptions of organizations' behavior as well (Lange and Washburn, 2012). The basic premise of the theory is that there is an imbalance between the cognitive processing that observers do in response to negative events as opposed to positive ones. People spend more time thinking about negative, as opposed to positive, events. They will look more extensively for causal information and their resulting actions and allegations will be more extreme (Fiske and Taylor, 2008). "People," Shaver (1985) observes, "are never blamed for doing good" (p. 3). Along with the theory comes the notion that such judgments as to the causes of human and organization behavior are changeable. In communications, SCCT (Coombs, 2007; see also Coombs, 2012, for a review) is derived from attribution theory.

CSR is proactive and prosocial, acting with regard to future concerns and aimed at avoiding an expectations gap between the organization and its stakeholders (Coombs and Holladay, 2012). In contrast to the voluminous literature on CSR, less than a handful of conceptual articles on CSI have appeared in recent years (Lange and Washburn, 2012; Lin-Hi and Muller, 2013). Only one empirical study has been reported on CSI, an event study by Groening and Kanuri (2013).

There is some evidence which suggests that investor responses to labor abuse allegations may be motivated by perceptions of unfairness. Public pension funds, labor funds, and socially responsible investment (SRI) funds emphasize longer term stakeholder interests by investing in firms that, among other things, have high labor standards (Aguilera *et al.* , 2007). Pension fund activists such as CalPERS (which manages the retirement funds for active California state employees and retirees) vigorously and publicly screen out firms that are liable to incur brand damage and/or deterioration of the firm's reputation due to deficits in CSR (Clark and Hebb, 2004). SRIs in particular are concerned with the social and environmental performance of firms (Lydenberg, 2005).

So we see that fairness may motivate investor decisions in addition to the traditional emphasis on financial performance. Despite those arguments we believe that investors' primary motivation is financial. Lamin and Zaheer (2012) did two studies side by side, one a survey of the general public and the other an event study of investors. Both groups responded to reports of overseas sweatshop conditions among the subcontractors of American companies. Lamin and Zaheer found that the general public is motivated primarily by fairness concerns whereas investor judgments were unaffected by the negative information. They concluded that investors are motivated primarily by financial concerns. Unlike our sample, that of Lamin and Zaheer responded to labor abuse allegations that were not punishable under US law. Their sample of investors was not convinced on purely moral grounds to take action against the companies in question. Thus, Lamin and Zaheer concluded what has long been held on Wall Street as a truth, that investors are primarily motivated by financial concerns. We concur with that assessment. Ours is a sample of domestic cases that were apparently headed for adjudication in most cases by US courts. It is our view that the investors in our sample would take a negative view of the allegations because of the potential costs associated with litigation (James and Wooten, 2006; Jang and Chen, 2009).

Contingency theory of public relations, a grand theory which makes prescriptive recommendations, predicts that threats to an organization's reputation that originate internally (such as the accusations we are studying) and that are long term in nature (some in our sample, such as Wal Mart, face recurring allegations) should involve the pursuit of an accommodative strategy (e.g. apologies) by the spokesperson. Investors may well have recognized that on a naïve level.

Much prior research has shown that shareholders pay attention to publicly announced information communicated about firms' CSR activities. Drawing from such information, shareholders may change their assessments of the future prospects of a firm. In the case of publicly announced information considered to be socially irresponsible, such as allegations of abusive labor practices, investors are likely to anticipate that firms will incur financial costs and a decline in future cash flows. Most obvious among financial costs are those associated with the costs of a lawsuit, including legal defense, legal fees, and back pay with the loss of a lawsuit or an out-of-court settlement (Bradford, 2004; James and Wooten, 2006). Initial lawsuits can trigger subsequent lawsuits, resulting in additional costs that further decrease the firm's cash flow and, therefore, the stock price (Bhagat *et al.* , 1998). Moreover, investors are likely to perceive a decline in cash flows due to decreased productivity of managers while handling the lawsuit (Ursel and Armstrong-Stassen, 2006). In the aftermath of abusive labor practices a firm may also incur significant financial costs in making changes to organizational policies and structures that safeguard against abusive practices (Terpstra and Kethley, 2002).

Publicly announced information concerning a firm's socially irresponsible behavior also exposes the firm to potentially damaging reputation costs, especially in cases involving discrimination (James and Wooten, 2006; Ursel and Armstrong-Stassen, 2006). Customer stakeholders take note of discriminatory practices and may boycott a firm's products (Pruitt and Nethercutt, 2002). The reputational penalty of a discrimination lawsuit may make it difficult and costly for a firm to attract and hold onto good employees (Karpoff and Lott, 1993). Within firms practicing discrimination, one is likely to see higher absenteeism, turnover, and job dissatisfaction, as well as diminished support from communities and institutions (Bradford, 2004). Like financial costs, reputational costs will signal to investors a rise in cost structures and a decrease in future cash flows.

Some empirical studies provide evidence of a relationship between specific types of abusive labor practice and stock returns. Epstein and Schnietz (2002) found that investors drove down the value of stock more for firms in industries perceived as labor-abusive than for firms in industries not perceived as labor-abusive following the announcement of failure of the 1999 World Trade Organization talks. An event study by Rock (2003) showed that announcements of firms engaged in sweatshop practices were associated with a statistically significant decline in the stock value of these firms. Ursel and Armstrong-Stassen (2006) found that announcements of age discrimination practices significantly reduced stock prices. McMillan-Capehart *et al.* (2010) reported significant increases in stock price in the days following a firm being named to DiversityInc.'s list of firms recognized for their diversity management. Lastly, a study by Wright *et al.* (1995), compared stock returns following announcements of firms receiving US Department of Labor Awards for exemplary affirmative action programs with announcements of damage awards paid out by firms to settle anti-discrimination lawsuits. Their findings show significantly positive returns for the former and significantly negative returns for the latter.

The evidence above suggests that in specific forms of abusive labor practices, most notably discrimination, shareholders will perceive a rise in financial and reputational costs that diminish the firm's future cash flows. However, in addition to acts of discrimination, abusive labor practices also include harassment and unfair compensation. Because these practices are regarded as socially irresponsible and cause firms to incur financial and reputational costs, we would expect investors to regard announcement of all abusive labor practices as detrimental to the firm's value. Accordingly: *H1*.

The announcement of an abusive labor practice will be associated with a negative stock price reaction.

2.2

Effects of explanations

Explanations given by company spokespeople can address the responsibility for alleged labor abuses in several ways (Bies, 1987; Schlenker, 1980; Sitkin and Bies, 1993). Sometimes justifications are used in conjunction with acknowledgments of responsibility. Exonerating and reframing accounts are examples of justifications. Exonerating accounts acknowledge responsibility but try to justify the actions in question as driven by some norm, value, or ideology of greater importance than the expectation that has been violated (Sitkin and Bies, 1993). Companies also acknowledge responsibility but try to justify their actions by reframing the alleged wrongdoing. In using reframing accounts, the company communicates that it has minimized the harm created by comparing it to a worse harm that would have resulted from some alternative action (Sitkin and Bies, 1993). A third way that companies justify their alleged wrongdoing is to offer excuses - also known as mitigating or causal accounts. With mitigating accounts, the alleged harm-doer communicates a reason for the action and thereby implies or asserts that the organization had no choice but to act as it did (Sitkin and Bies, 1993), which should reduce the amount of blame that is placed on the shoulders of the organization and the people who speak for it. A consideration that is relevant here is that, when company spokespersons decide how to respond to an alleged labor abuse, they understand that their communication is going out to numerous audiences at once, namely, employees, investors, consumers, and the general public. Spokespersons likely understand that the "spin" that they put on their response can influence, not only investor behavior, but the future behavior of employees as well. They are likely going to try to deter employees from filing future lawsuits. The messages that are meant to mollify employees may alienate consumers and, via the anticipation of the stock market of consumer reaction, may alienate investors as well. Consumers often transmit messages about a company via word-of-mouth, which is a very difficult channel to erase later (Coombs, 2007). Coombs (2012) points out that improper crisis management practices can do more harm than good to an organization's reputation.

A somewhat different approach used by companies is to deny responsibility for alleged abusive labor practices. By denying that any harm occurred in the first place, or claiming that the allegations have no legitimate basis, a spokesperson might seek to avoid any issues of responsibility altogether (Schlenker, 1980)[1]. In stark contrast to explanations in which a company communicates denial is the penitential account (Bies, 1987; Schlenker, 1980). Penitential accounts are simply apologies. Apologies are an accommodative approach to crisis management, what Benoit (1995) refers to in image restoration theory as "mortification strategies." With regard to CSR and CSI, apologies serve to re-align the expectations of the organization and its stakeholders (Coombs and Holladay, 2012). With respect to issues management, apologies can bring about organizational change if the corporation agrees as part of the apology not to repeat the violation in the future (Coombs and Holladay, 2008). In that way, apologies can prevent a crisis (Coombs, 2012). Attorneys generally advise their clients not to apologize because it communicates an unambiguous admission of guilt (Cohen, 1999; Coombs and Holladay, 2008; Tyler, 1997).

There is a rich literature on the effects of explanations on perceptions of wrongdoing (see Bobocel and Zdaniuk, 2005, for a review). Most such studies were laboratory and critical incidents studies performed by Bies, Folger, and their colleagues in the 1980s that looked at the effects of excuses (again, mitigating accounts) and justifications (again, exonerating and reframing accounts) on the fairness judgments of persons directly affected by the act in question (Bies and Moag, 1986; Bies and Shapiro, 1987, 1988; Bies *et al.* , 1988; Folger and Martin, 1986; Folger *et al.* , 1983). In a few instances, the fairness judgments that were examined looked at third parties as the source of those judgments, i.e., members of the general public who read about layoffs in a company with which they have no direct association (Bobocel and Debeyer, 1998; Skarlicki *et al.* , 1998). In any case, the research showed that all types of explanations tested had an effect on perceptions of wrongdoing. Justifications, excuses, and apologies are all instances of "offensiveness strategies" in the communications literature (Coombs, 2015). Coombs points out that such strategies are seldom used by corporations. We are making the argument that they should be used more often.

The motives behind third party judgments can be moral (motivated by the perception of injustice), instrumental (motivated by concern for one's own outcomes), or both (O'Reilly and Aquino, 2011; Skarlicki and Kulik, 2005). In the case of investors as third parties, their judgments regarding the firm's treatment of its employees can be moral (i.e. concerned with the employees' welfare), instrumental (concerned about the potential financial losses attending a lawsuit, a regulatory fine, a boycott, or a strike), or relational (concerned with the legitimacy of the firm) (Aguilera *et al.* , 2007). With an instrumental response, investors can decide to sell their interest in a company that is accused of widespread discrimination simply because they are concerned about the potential effects, for example, of a class action lawsuit on the value of their holdings. There, investors are anticipating a moral judgment by a different third party (e.g. a judge, a jury, or a regulatory agency), which may act to punish the alleged harm-doer.

Because shareholders have considerable corporate power, they will take decisive action if they believe that management is following policies that do not maximize stock value. A decline in stock value in immediate response to an announced abusive labor practice may lead to managers losing their jobs, which may have a greater negative impact than the costs imposed through the courts and regulatory agencies (Ursel and Armstrong-Stassen, 2006). Accordingly, offering justifications may act to reduce the likelihood that managers will lose their jobs: *H2.*

Justifications and excuses given by a company spokesperson to explain accusations of abusive labor practices will result in a less negative value for the company's stock price.

Instead of trying to explain alleged abusive practices, firms may deny that the allegation has merit and/or claim that it is totally lacking in validity. Denials have received very little research attention in the literature on social psychology and management, although they are mentioned in passing by Schlenker (1980). When a denial is issued by a company spokesperson, that is likely to be seen as an attempt by management to escalate the conflict with their employees by employing a forcing strategy that poisons the relationship between employer and employees (Thomas, 1976), such a "digging in of the heels" is likely to be seen by employees and investors alike as a declaration of war, an instance of escalation of commitment, in which a party to a conflict persists in a course of action that is inadvisable (see Ross and Staw, 1993). In the legal context, there are numerous potential consequences of using denials as a strategy when investors are the audience (see James and Wooten, 2006; Jang and Chen, 2009). It gives off the indication of the case going to litigation if the employee(s) does not/do not back down. Whatever the legal outcome, litigation involves tremendous uncertainty and impacts indirect costs, including management distraction and difficulty obtaining credit on favorable terms. Investors likely recognize that and factor those considerations into their assessment of the firm's value. Coombs and Holladay (2012) recommend that CSR involve collaboration with employees as stakeholders. We see no reason why that would not apply to CSI as well. Denial is stonewalling - the opposite of collaboration. As Jang and Chen (2009) point out:

The legal liability incurred by an organization diminishes with increased use of defensive strategies [such as denials] [...] but this approach suggests denial of responsibility, corporate arrogance, and inappropriate defensiveness and may ultimately increase negative public perceptions of the organization.

Another reason why denials do not work comes from Coombs (2014), who, in discussing SCCT, recommends that if there is some, even minimal responsibility, the organization's spokespeople should take a more victim-centered approach. Denials work if the organization is truly not responsible for a crisis. However, we believe that investors know that, in the corporate world the truth will eventually get out (Coombs and Holladay, 2012). Stakeholders want organizations to take responsibility (Coombs, 2014). If the organization denies responsibility and it is later discovered that it is culpable, matters will get even worse for the corporation.

As alluded to above, legal scholars typically recommend denials in an effort to avoid an admission of responsibility, which may open the firm up to legal liability (Cohen, 1999; Coombs and Holladay, 2008; Tyler, 1997). However, the admission of responsibility for an alleged harm by a company spokesperson has been shown to have benefits for the firm, including positive evaluations of character (Schlenker and Darby, 1981), enhanced trust in the organization (Tomilson *et al.* , 2004), enhanced perceptions of organizational integrity (Ferrin *et al.* , 2007), and more positive views of the organization's reputation (Lyon and Cameron, 2004) - all benefits that are foregone when spokespersons employ denials. In addition, a denial may be interpreted by the employees in question as an insult, implying that they are liars in making the accusation in the first place and constituting a breach of interactional justice, which includes the quality of the interpersonal treatment affecting employees and likely noticed by investors as third parties. We believe therefore that denials will have a negative effect on the stock price even though such assertions may help to protect the firm from legal liability: *H3.*

Denials of company wrongdoing given by a company spokesperson in response to accusations of abusive labor practices will have a negative effect on the company's stock price.

3.

Sample

We collected data on announced alleged abusive labor practices in press releases between 1990 and 2009 found in PR Newswire and Business Wire in the *LexisNexis* database. The event date was the date of the first reported press release. In some cases, press releases appeared once or twice in a period that extended to a maximum of three days following the initial announcement. All subsequent announcements, however, were either repeated or excerpted versions of the first announcement. This is to say that subsequent announcements contained no new information regarding the announced alleged abusive labor practice.

It is important to note here that all data for the study were drawn from archival sources. Archival sources are nonreactive in the sense that the measures are made unbeknown to the people who are producing those measures and thus they do not respond to the act of being subjected to measurement as they are likely to in a laboratory study or a survey questionnaire (Webb *et al.* , 1981). Because our independent, dependent, and control measures are drawn from different archives, they are not subject to common method variance. To our knowledge, very few if any organizational justice studies have been performed using wholly archival measures.

Following prior event studies, we eliminated announcements made by firms that conveyed potentially confounding corporate news that may also affect investors' reactions (McWilliams and Siegel, 1997). Such confounding events include simultaneous announcements such as mergers and acquisitions, executive management changes, stock splits and repurchases, divestitures, earnings and dividend announcements, and new product introductions. After eliminating 44 potentially confounding events, our final sample contained 243 announcements made by 119 firms. In addition, there were no apologies given by any firm in the sample, which is why we do not include a justification for any hypotheses involving apologies in this report.

Two of the study's authors then independently read announcements and identified those which contained excuse/justification accounts and those which contained denial accounts. Agreement in identifying announcements containing explanations was 94 percent, suggesting high inter-reviewer reliability. Differences in reviews were discussed and resolved. Table I shows excerpts of explanations from announcements for each category.

4.

Methodology

4.1

Dependent variable and the event study method

Our dependent variable is the firm-specific unexpected change in stock value associated with the announcement of an alleged abusive labor practice event. The event has an effect on the firm's financial performance if it results in an abnormal movement in the price of the firm's stock. As mentioned earlier, we use the event study method to test whether this abnormal movement in stock value, or "abnormal return (AR)," has a significant impact on a firm's financial performance. The AR is the actual *ex post* return of the stock following the event minus the expected normal return of the stock during the same time period as if the event had never been announced.

To estimate ARs, we used Cowan's Eventus software and the Center for Research in Security Prices database for stock prices and returns. As a first step in conducting the event study we estimated the expected normal return of a given stock using the Fama-French-momentum model (Carhart, 1997; Fama and French, 1993, 1996)[2]. We then calculated ARs as the difference between the expected and actual value of the stock measured as a percentage. ARs were calculated for the event date (t_0), which is the first public release date of the information, and also for individual days before and after the event. Following standard practice in event studies (McWilliams and Siegel, 1997), we summed ARs over a number of days before and after the event to derive a measure of the cumulative ARs (CARs) for each event. For example, an event window for CARs might run from two days before the event day to two days after the event day (t_{-2} -t_{+2}). In this manner, it was possible to determine if and when an alleged abusive labor event had an impact on a firm's stock. We chose for our event window the 11-day period beginning five days before the announcement and ending five days after the announcement (t_{-5} - t_{+5}). Event windows that cover several days have been widely used in studying stock market reactions to capture potential leakage of information prior to the event and slow responses or reevaluations after the first public announcement of the event (Bindu and Zhang, 2009; Chatterjee *et al.* , 1992; McWilliams and Siegel, 1997; Srinivasan and Bharadwaj, 2004). Accordingly, by choosing an 11-day event window, we were able to determine the stock market reaction on the day of the announcement and for cumulative periods before and after the announcement. We also report results for windows from t_0 to t_{10} and t_0 to t_{15} to test if CARs persist beyond day five.

4.2

Analysis

To test *H1* , we first conducted an event study to determine the ARs and CARs over the 11-day event window. We followed prior event studies in using the parametric standardized cross-sectional Z -statistic to show if ARs and CARs are statistically significant, and the nonparametric generalized sign Z -statistic to test the significance of the proportion of positive ARs and CARs (McWilliams and Siegel, 1997; Srinivasan and Bharadwaj, 2004). The cross-sectional Z -statistic adjusts for serial dependence (Mikkelson and Partch, 1988) and for a possible increase in variance around the event date (Boehmer *et al.* , 1991). To test *H2* and *H3* , regarding the effects of explanations and denials, we used t -tests to evaluate mean differences in ARs and CARs between firms that used explanations and denials and those that did not. Since the independent variables (the explanations and denials) are drawn from individual responses made by company spokespeople and dependent measures are drawn from stock market results, the study qualifies as a cross-level study (see House *et al.* , 1995).

5.

Results

Table II reports summary statistics and correlation coefficients for variables used in the analyses.

5.1

The effect of alleged abusive labor practices on equity returns

Table III contains the results for the market response to all announcements of alleged abusive labor practices. These results indicate an immediate market response to announcements. On the day preceding the event, 45.7 percent of firms had positive ARs. That number declines to 42.4 percent on the event day. In support of *H1* , we observe a significant negative AR of -0.24 percent on the event day (p <0.05). The median AR is -0.29 percent. Following Karpoff *et al.* (2008), we calculate the dollar value effect by multiplying each firm's AR on the event day (t_0) by the firm's market capitalization one day before the announcement. The mean and median dollar losses are $138.43 and $18.44 million, respectively. The total dollar loss summed over all firms is $33.64 billion.

5.2

The effect of explanations on equity returns

Table IV presents the results from comparing the market response to announcements that do and do not contain excuse/justification accounts. In support of *H2* , we find that investor reaction was significantly less negative for announcements offering these accounts than for those that did not. Event window t_0 -t_{+2} is significant at p <0.05 (t =-1.913), event window t_0 -t_{+3} is significant at p <0.001 (t =-3.543), and t_0 -t_{+4} and t_0 -t_{+5} are both significant at p <0.01 (t =-2.931 and t =-2.773, respectively). The results suggest that investors delayed their upward revision of stock value for a period covering days 0-2 through 0-5 after announcements communicating excuse/justification accounts for alleged abusive labor practices.

Table IV also shows the market response to announcements that denied alleged labor abuse practices. Supporting *H3* , we find that investors reacted more negatively to announcements in which firms denied alleged abusive labor practices than to announcements without denial accounts. Event windows t_0 -t_{+1} and t_0 -t_{+2} are both significant at p <0.05 (t =1.833 and t =2.138, respectively), t_0 -t_{+3} is significant at p <0.01 (t =2.547), and t_0 -t_{+4} and t_0 -t_{+5} are both significant at p <0.05 (t =2.011 and t =1.689, respectively). Accordingly, we see that investors delayed their downward revision of stock value for a period covering days 0-1 through 0-5 after the initial announcement made by firms that denied alleged abusive labor practices.

Further support for *H2* and *H3* appears in the third row block in Table IV. These results show that investor reaction was significantly more negative for announcements that denied wrongdoing than for announcements with excuse/justification accounts. Event window t_0 to t_{+1} is significant at p <0.05 (t =-1.957), t_0 -t_{+2} is significant at p <0.01 (t =-2.452), t_0 -t_{+3} is significant at p <0.001 (t =-3.960), and t_0 -t_{+4} , and t_0 -t_{+5} are both significant at p <0.01 (t =-2.912 and t =-2.848, respectively).

5.3

Cross-sectional analysis

Results in Table IV do not control for other factors that could influence the market's response to announcements of abusive labor practices. We therefore include a multivariate regression as a more robust test that controls for other cross-sectional differences that may impact the information effect on the market reaction:

CARi=[beta]0+[beta]1ExplanationsiorDenialsi+[beta]2ROAi+[beta]3MVEi+[beta]4Multiplei+I µi

where for each announcement *i* , the dependent variable is the CARs. We run the regression for the same event windows and independent variables (*Explanations or Denials*) as reported above. Our control variables are return on assets (*ROA*), log of market value of equity (*MVE*), and whether firms in our sample had more than one announced abusive labor practice (*Multiple*). We include *ROA* to account for the possibility that the market might act differentially according to the firm's performance. More profitable firms receive more positive media coverage, whereas less profitable firms receive more negative media coverage (Lamin and Zaheer, 2012). Ursel and

Armstrong-Stassen (2006) report that opportunities for age discrimination charges increase in firms that face financial difficulties. *MVE* controls for how investors might consider the size of the firm in evaluating the impact of an abusive labor practice[3]. Larger firms often get more media coverage and may experience a weaker performance effect following an accusation (Lamin and Zaheer, 2012). A firm's size likely relates positively to observer assessments of corporate culpability (Lange and Washburn, 2012). Larger firms, for instance, typically pay higher punitive and compensatory damages than small firms in discrimination lawsuits (Bradford, 2004). The variable *Multiple* controls for potential differences in how investors might react to announcements for firms that have had more than one announced abusive labor practice. As Coombs (2007) suggests, firms with a history of reputational damage from a crisis are likely to suffer greater reputational damage in a successive similar crises than firms that have not experienced a similar prior crisis.

Table V presents the results of the regression analysis for cumulative event windows from days t_0 to t_{+2} through t_0 to t_{+5} and shows that they are consistent with the t -test results. We also find that higher pre-event returns on assets are significantly related to CARs for several windows, suggesting that investors may react more strongly to alleged abusive labor practices in higher performing firms. Firm size and multiple announcements appear to have little impact on the market's reaction.

6.

Discussion and conclusion

In this paper, we suggest that investors, as third parties to an alleged wrongdoing, tend to avoid investing in companies that are alleged to have committed labor abuses. Further, we argue that this negative effect is offset somewhat when company spokespeople communicate excuses and justifications as explanations for the event. We also suggest a negative effect occurs when company spokespeople offer denials as explanations for the event.

Our results strongly support these hypotheses. First, as predicted, investors, who are neither the direct target of an abusive labor practice nor the perpetrator of the act, react negatively to the harm-doer's behavior by adversely influencing the firm's stock value.

Second, our prediction also held for how investors as third parties react to announcements that communicated explanations containing excuses and justifications for an alleged abusive labor practice. In using these accounts, company spokespersons appear to have allayed some of investors' initial concerns about the consequences for the firm, substantially upgrading the firm's stock value. The response, however, is not immediate as investors appear to need additional time to reconsider and revise their initial response. While we cannot fully explain why this may be, the market in some cases may require more time to absorb the effects of an event (Oler *et al.* , 2008). Investors' responses at the time of an announcement may be incomplete when events disclose more complex information (Dumay and Tull, 2007). This appears to be the case in announcements that contain explanations. As McMillan-Capehart *et al.* (2010) report, announcements that positively affect a firm's reputation may take longer for investors as third parties to recognize fully.

Third, as hypothesized, our findings show that announcements in which company spokespeople offered denials as explanations for the event were associated with a decline in stock value. Our findings are consistent with those of Lamin and Zaheer (2012), indicating that the investor's primary motivation in the majority of cases is instrumental, i.e., they are primarily concerned about the potential effects of litigation on future cash flows. In other words, our findings pertain more closely to instrumental models of third party judgments (see Skarlicki and Kulik, 2005) rather than to moral or fairness-related models of such judgments (see O'Reilly and Aquino, 2011).

As in explanations containing excuses and justifications, the market response is delayed by several days. Here too, investors may need additional time to reconsider and revise their initial response.

6.1

Implications for theory

We note at least three important contributions of our study: it adds to the very small number of empirical studies on third party behavior; it adds to research on explanations a new dependent variable on a new, organizational scale - the effects on the financial performance of the company; and it adds to our understanding of the role that denials play when a third party considers an allegation of harm-doing.

Aguilera *et al.* (2007) advance a multi-level theory which identifies the actors who are pushing an organization to become more socially responsible and their motives for doing so. Aguilera *et al.* would characterize the alleged labor abuses in our study as CSI and the type of social change that is sought in those events to be reactive rather than proactive. Like our study, their theory analyzes behavior at the individual (in our sample, company spokespersons) and organizational levels. They rely on the organizational justice literature in deriving motives for CSR (namely, instrumental, relational, and moral motives). Our study therefore functions as a test of the Aguilera *et al.* (2007) multi-level theory. Our use of data on the use of explanations and of changes in stock price as a dependent variable answers Aguilera *et al.* 's call for using specific, measurable behaviors relative to CSR and the conditions which give rise to it, since CSR and CSI taken together are such broad subjects.

6.2

Implications for practice

If a corporate spokesperson wishes to "cushion the blow" of an alleged labor abuse, or of a similar instance of bad news for the firm, he or she is recommended to pursue the following guidelines: the spokesperson should employ excuses and justifications while avoiding issuing denials. The usage of the word "excuse" is not pejorative here; an excuse is simply a reason communicated by way of explanation. In lieu of a denial, the spokesperson might say that the organization is investigating the situation or is cooperating with an external investigation. Denials communicate defensiveness and investors may wonder in the face of a vociferous denial that, to paraphrase Shakespeare, perhaps the spokesperson doth protest too much. As mentioned above, a denial may further anger the complainants in the situation, since a strong denial sends the message that those complainants are lying. In instigating or cooperating with an investigation, the firm is communicating that it has nothing to hide.

6.3

Limitations, strengths, and future research

One limitation of our study is that an 11-day window increased the chance that other, unreported, confounding events occurred. However, because we eliminated confounding events to the best of our ability and given the significance of our findings, we feel confident that the results are an accurate representation of third party responses to explanations. Another possible limitation is that there are a variety of factors that may influence the effectiveness of explanations which we were unable to measure, given our focus on secondary data sources. Examples include perceived sincerity of the deliverer, context, outcome favorability/importance/severity, and informational uncertainty (for a review, see Bies, 2013).

A methodological strength of our study is that, since our measures were archival, our subjects did not react to the fact that their behavior was being measured. In addition, there was no common method variance in those measures as well. Our study does not remove the need for laboratory and field research on explanations and third party effects. Instead, all three types of research are needed and the results of all three should be interpreted alongside one another so that the weaknesses of each method can be offset by the strengths of the others.

With respect to future research, one direction would be to try and measure the mediating and moderating variables that intervene in the context of investor judgments. For example, a single allegation of labor abuse could be examined in a single company. That event could be presented as a real or hypothetical situation to a group of investors, both present and prospective shareholders, and judgments of investors as third parties could be measured by a survey method. In this way, if fairness considerations are truly involved, fairness judgments would be measured, not inferred as they are in the present study. The resulting research would not make use of the event study methodology, but could make use of multiple, other methodologies such as a policy-capturing method (a sort of hybrid between a laboratory study and a survey questionnaire) and interviews with investors. By such means, researchers can also measure variables as prospective moderators, variables mentioned above like perceived sincerity of the deliverer, context, outcome favorability/importance/severity, and informational uncertainty. With research questions such as these, multiple methods provide the best view of the phenomenon as a whole, not unlike the proverbial blind men and their perceptions of the elephant.

Notes

1. We are grateful to Robert Folger for his suggestions regarding this paragraph.

2. The CRSP equal-weighted index, composed of stocks listed on the NYSE, AMEX, and NASDAQ, serves as the market index. We also used the market model () to test abnormal movement of the price of the firm's stock and the results are qualitatively the same.

3. As a further robustness check, we tried firms' total revenues and employment as alternative metrics for size, and the results are qualitatively the same.

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