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A Study on the Relationship between Social Responsibility, Earnings Transparency and Stock Price Crash Risk

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A B S T R A C T

Stock price crash is a phenomenon in which the stock price suffers a severe and abrupt negative adjustment. One of the most important ways to manipulate accounting information is to accelerate the identification of good news versus delaying the recognition of bad news in earnings. However, there is always a final level of accumulation of bad news in the corporate and reaching the final level, the bad news will be published all at once. This leads to a fall in stock prices of the corporate. The main objective of this study is to investigate the relationship between social responsibility, earnings transparency and stock price crash risk in listed corporates on Tehran Stock Exchange. The studied sample of this research includes 95 listed corporates on Tehran Stock Exchange from 2009 to 2013. Multivariate regression is used to test the hypotheses of this study. The overall results of the research indicate that there is a negative significant relationship between social responsibility, earnings transparency, and crash risk. That is to say, the more the social responsibility and earnings transparency increase, the less the crash risk will be.

Keywords: Social Responsibility, Earnings Transparency, Stock Price Crash Risk.

INTRODUCTION

Stock Exchange as a place for the formation of financing and investment flow, plays a major role in increasing the productivity of the country and thus in line with the progress of the country, it is critical. However, the important thing in this field is the correct formation of the flow by the existent forces in the market. This, itself is subject to the projects with maximum efficiency to be recognized by investors. The decision to identify such projects always requires the use of reliable and relevant information, to be used in the decision models. In this regard it is noteworthy that according to accounting research business units managers will always be able to accumulate certain amount of bad news in the corporate to do the policy of "delay in the issuance of bad news and accumulating them as confidential information". This is due to the factors such as costliness of the policy or in general lack of management ability to continue this

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action (such as changes in business unit management). Eventually, when the accumulated negative information volume reaches the final amount, the managers will not be able to prevent the news issuance to the market and investors. With the release of the news in the market, investors with the new obtained information, revise their prior beliefs that were the basis for the stock current price of the corporate and they found their expectations based on new information. This will lead to sudden and negative adjustment of the corporate's stock price, which in financial literature it is referred as stock prices falling or stock prices crash.

In order to properly guide decision-making on the optimal allocation of capital, information plays a crucial role in the capital market performance. What information users seek is to increase the reliability or decrease the risk. However, too much information does not lead to an increase in reliability, it is the transparency of information that reduces the uncertainty. Lack of clear information on the market will increase transaction costs and market failures. Therefore, in many recent failures in capital markets, lack of transparency is regarded as one of the influential factors[1].

In general, the concept of corporate social responsibility in recent years, due to the growth of non-governmental organizations, protest movements against corporates power, increase in social awareness, development of capital markets, development of public corporates and financial and moral scandals of large companies, has become the dominant paradigm in the corporates government atmosphere. Today, different social groups have been agreed with each other on the idea that the corporates must serve the needs of the people, not the people to serve the needs of large companies. It should be noted, corporates' responsibilities towards society and the general public are beyond service delivery and commodity supply. If companies do not pay attention to their social objectives and continue to seek out their operational costs, environment pollution, poverty, disease, discrimination and chaos will prevail in their environments and if they do not consider the issue with a little forethought, the problems at the end will befall them too.

THEORETICAL FOUNDATION AND LITERATURE REVIEW

Today, due to the complexity of the corporates relationships with each other and with the government and people in the society, a situation arose that corporations should be held accountable not only to shareholders but also to the public. In fact, due to the lack of attention to the interests of other social groups as well as the environmental impacts of business units activities, the accounting concept of social responsibility was raised in accounting theoretical issues.

Social responsibilities accounting is a part of the accounting knowledge aimed at measuring and reporting the social impacts (social costs and benefits) resulted from the activities of the business units. Since each business unit is a part of the society in which it operates, and is constantly interacting with other members of the society and according to the unwritten social contracts between society members, which have been enacted to protect the interests of all members, it is necessary for obligations and responsibilities of business units to not be limited to protecting the interests of shareholders, but also other obligations and responsibilities must be considered in relation to other social groups such as creditors, employees, customers and vendors and existent groups in society as well as the surrounding environment. Social accounting can be defined regard to the information published by an organization that allows the beneficiaries to assess the organization's performance in dealing with (positive and negative) social issues[2].

In democratic societies, the access to transparent information is considered as the basic rights of the individuals. Citizens have the right to have sufficient information about their stewards' (governments and public institutions) decisions and the foundations of these decisions. This is the fundamental essence of stewardship. Transparency is also necessary for the economy, because it improves the allocation of resources and is directly concerned with efficiency and economic growth. Lack of transparent information on the market will increase transaction costs and market failures. Therefore, in many recent failures in the capital markets, lack of transparency is regarded as one of the influential factors[1]. Conducted studies show that providing more transparent information leads to the reduction of information risk and information asymmetry. Therefore, investors' uncertainty about the company's financial information will decrease[3]. Lack of information transparency gives the managers more opportunity to cover the bad news from the company's stakeholders; and finally, when these accumulated bad news release in the company, it causes a severe and negative adjustment in the stock returns or the stock price crash[4].

In recent years, due to the occurrence of certain events, the phenomenon of stock prices crash has found an important role among the accounting and financial researchers. The most important events include bankruptcy of big corporates like WorldCom, Enron and stock prices crash of these corporates in the capital market, or the experience of stock prices crash on US Exchanges in October 1987 and the economic crisis in 2008 that led to the stagnation of the capital market in most of the world's major exchanges.

Stock prices crash or negative skewness of stock returns is a phenomenon in which a corporate's stock price suffers a severe negative and sudden adjustment. In fact, the falling in stock prices is known as a negative and sudden revision in investors' expectations about a company's stock[5]. In all researches conducted in the context of stock prices crash, two main components are known. First, using management methods, the management reports the corporate's earnings or income somewhat higher than the actual amount. This increases the investors' optimism about the corporate's permanent income and ultimately it leads to increase in the corporate's stock price higher than the actual amount (and so-called the stock price faces a price bubble phenomenon (i.e. it experiences an unfounded increase)), or with a special motivation, the management tries to hide the bad news for investors. According to accounting researches business units managers will always be able to accumulate certain amount of bad news in the corporate to do the above mentioned policy. This is due to the factors such as costliness of the policy or in general lack of management ability to continue this action (such as changes in business unit management). Eventually, when the accumulated negative information volume reaches the final amount, the managers will not be able to prevent the news issuance to the market and investors. The occurrence of any of these two actions on the part of management can prepare the ground for occurrence of stock price crash. Second, accounting system and its use is in the direction of this action of management that allows the management to do that[6].

The phenomenon of stock prices crash is important for investors because it is always useful for stock portfolio and risk management to know the specific characteristics of a company that make the prediction of sever fluctuations in price and especially the stock price crash possible. According to Saunders the significant point regard to the severe losses risk that is derived from stock prices crash, is that unlike the risks associated with systemic fluctuations of stock prices, such losses will not decrease by the diversification of the portfolio and the only way to deal with such risks is to identify the stock exposed to this risk due to the factors that cause this type of risk. On the other hand, all stock option pricing models need to know skewness and the risk of stock prices crash. In this situation, the increase in the phenomenon of stock prices crash causes investors' pessimism about the investment in the stock market. It could ultimately lead the investors to draw the investment resources out of the Stock Exchange. The risk of stock price crash is important for investment decisions and risk management[7].

If corporates bring the social responsibility close to standards with high levels of transparency and involve in bad news less, the risk of stock price crash will come down. The studies results found that social responsibilities and earnings transparency lead to the reduction of stock price crash risk. In other words corporates' social responsibility performance is associated with risk of future stock price crash. In addition, the relation of social responsibilities and the risk of stock prices crash in corporates with corporate governance is more prominent with less impact or lower level of institutional ownership. The role of social responsibilities is important when corporate governance mechanisms, such as monitoring by the board or institutional investors, are weak[8].

Therefore, in this research the role and impacts of social responsibilities, earnings transparency and stock prices crash are examined. In other words, the present study seeks to answer the question that is there a significant relationship between social responsibilities, earnings transparency and stock prices crash of listed corporates on Tehran Stock Exchange.

Kim et al, on a study titled ″Social Responsibilities and the Risk of Stock Prices Crash″, assessed whether the reduction of corporates' social responsibility leads to the risk of stock prices crash. The results indicated that if corporates bring the social responsibility close to standards with high levels of transparency and involve in bad news less, the risk of stock price crash will come down and social responsibilities lead to the reduction of stock prices crash risk. Social responsibility performance is negatively associated with risk of future stock price crash. In addition, the negative relation of social responsibilities and the risk of stock prices crash in corporates with corporate governance is more prominent with less impact or lower level of institutional ownership. The role of social responsibilities is important when corporate governance mechanisms, such as monitoring by the board or institutional investors, are weak[9].

Hamm et al., in their study examined the role of earnings management guidance and stock prices crash. Their research results indicate that there is a significant relationship between earnings management guidance and the risk of stock prices falling and crash. That is to say, the more the earnings management is guided and organized, the more the risk of stock price crash increases[10].

Francis et al., in a research entitled " Firms' Real Earnings Management and Subsequent Stock Price Crash Risk″, using a large sample of US companies for the period 1994-2004, through analysis of companies by fixed effects, various measures and the probability of companies' crash, have found that real earnings management in firms has a significant positive correlation with the stock price crash[11].

Callen and Fang, on an investigation examined the relationship between institutional investors and corporate's stock price crash. They evaluated two opposing views of institutional investors: monitoring view against expropriation. The results of this study suggest that there is strong evidence regard to an inverse relation between institutional ownership and stock prices crash in the future[12].

Kim and Zhang, have done a research in which they examined the relationship between accounting conservatism and stock price crash in America. The results show that conservative accounting prevents the accumulation of bad news by managers, and this reduces the likelihood of a sudden drop in the stock price[8].

Dianati et al., reviewed the impact of working capital management based on the cash conversion cycle (Gitman) on reducing the risk of stock price falling (crash). To measure the working capital management in this research, Gitman's cash conversion cycle (1974) was used and the skewness negative coefficient model of Chen stock returns (2001) was applied to measure the stock prices crash of 59 companies listed in Tehran Stock Exchange in the period from 1999 to 2011. In this study, strong evidence provided that working capital management significantly reduces the risk of stock prices falling[6].

Forooqi et al., studied the effect of the lack of financial information transparency on future stock price crash risk in companies listed in the Tehran Stock Exchange. The study population included companies listed in the Tehran Stock Exchange in the time span of 2001 to 2009, and 90 companies were selected as sample of this research. The findings of this study suggested that there is a direct correlation between the lack of transparency of financial information and future stock price crash risk. Therefore, it can be concluded that the increase in lack of transparency in financial reporting lead to the increase in future stock price crash risk. The results of this investigation also showed that when there is information asymmetry between managers and investors, the effect of lack of financial information transparency on accretion of future stock price crash risk is higher[13].

RESEARCH HYPOTHESES

First hypothesis: there is a significant relationship between social responsibilities and risk of stock prices crash of listed corporates on Tehran Stock Exchange.

Second hypothesis: there is a significant relationship between earnings transparency and risk of stock prices crash of listed corporates on Tehran Stock Exchange.

METHODOLOGY

In this study, the correlation between the research variables is tested first. Then, if there is a correlation between the variables, multiple regression models will be estimated. After a brief analysis of the data used, first, White test is applied to detect heteroscedasticity, Breusch–Godfrey test is used for autocorrelation problem and also Jarque-Bera test is utilized to examine error terms normal distribution. We also continue using F-Limmer test to indicate that there are individual differences, so-called heterogeneity, in the sections or the sections are homogeneous together. Hausman test is applied to determine the cross-sectional units difference being fixed or random. Then the research model is estimated and the results will be analyzed. Excel software is applied to analyze the collected data and Eviews 6 software is used to test the hypotheses and also additional tests to ensure independent regression model.

RESEARCH MODEL AND VARIABLES

First Hypothesis Model:

$$CRASH\_RISK_{i,t} = \beta_0 + \beta_1(CSR\_SCORE_{i,t-1}) + \beta_2(CRASH\_RISK_{i,t-1})$$
$$+ \beta_3(MB_{i,t-1}) + \beta_4(SIZE_{i,t-1}) + \beta_5(LEV_{i,t-1}) + \beta_6(ROA_{i,t-1}) + \varepsilon_{i,t}$$

Second Hypothesis Model:

$$CRASH\_RISK_{i,t} = \beta_0 + \beta_1(CRASH\_RISK_{i,t-1})$$
$$+ \beta_2(TRANS_{i,t-1}) + \beta_3(MB_{i,t-1}) + \beta_4(SIZE_{i,t-1}) + \beta_5(LEV_{i,t-1}) + \beta_6(ROA_{i,t-1}) + \varepsilon_{i,t}$$

Dependent Variable:

$CRASH\_RISK_{i,t}$: Risk of stock prices crash

Independent Variables:

$CSR_{i,t-1}$: Social responsibility

$TRANS_{i,t-1}$: Transparency of earnings

Control Variables:
$LEV_{i,\, t-1}$: Leverage
$SIZE_{i.t-1}$: Size of the corporate
$ROA_{i,\, t-1}$: Return on assets
$MB_{\ i,\, t-1}$: Market value to book value of the corporate

Dependent variable:

Risk of stock prices crash: if the stock price of a corporate in the year under review, has faced a sharp decline, the stock price of that corporate has fallen in that year. As the severe reductions in stock price may be the result of general decline in market prices, the overall situation in the market should also be noted and the sharp reduction in stock return compared to the returns of the market should be defined (Hutton et al, 2009). According to the research hypothesis, the study dependent variable is the risk of stock prices crash, to measure which the skewness negative coefficient model (Chen, 2001) is used as follows:

$$CRASH\_RISK_{i,t} = -\,[n\,(n-1)^{3/2} \sum W_{i,t}] \,/\, [(n-1)\,(n-2)\,(\sum W_{i,t})^{3/2}]$$

In the above model, $W_{i,\, t}$ indicates the specific monthly returns of firm i for month t and n is the number of monthly returns observed during fiscal year. In the above model, the more is the skewness negative coefficient, the more the corporate will be at risk of stock prices crash.
"Specific monthly returns of firm" that is shown by w (formula number one) is equal to the natural logarithm of number one plus the remaining number ε_t, which is calculated through the formula number two.

$$W_{j,t} = ln(1+\varepsilon_{j,t}) \quad r_{j,t} = \alpha_j + \beta_1 r_{m,t-2} + \beta_2 r_{m,t-1} + \beta_3 r_{m,t} + \beta_4 r_{m,t+1} + \beta_5 r_{m,t+2} + \varepsilon_{j,t}$$

In the formula number two, $r_{j,t}$ is the stock return of firm j in month t and $r_{m,t}$ is the monthly return of the market (based on the market index).

Independent Variables:
Social Responsibility: Griffin and Barney defined social responsibility as: social responsibility is a set of duties and obligations that the organization should done to preserve, care for and assist the community in which it operates (Fleming, 2002).
Corporate's Social Responsibility Dimensions: In most of researches on the ethical issues, in order to determine the level of corporate social responsibility, different dimensions, including employees, customers, the environment, hygiene and health, education, rural development and institutions in the community are taken into account (Sandhoo and Kapur, 2010). In this study, following Zaman Khan (2010), Sandhoo and Kapoor (2010) four dimensions of customers, employees, the environment and institutions in the community are considered for social responsibility. These four dimensions' descriptions are presented briefly in the following.

1. The first dimension of corporate social responsibility is in relation to customers and includes those activities that a corporate do to ensure customers' satisfaction, so that customer care principle and continuous improvement principle are two of the principles regarding the quality management (Standard ISO, 2010).
2. The second dimension of social responsibility is human resources that constitute an important part of the community and no company can be successful without its

employees' heartfelt association. Accepting social responsibility in lieu of health and safety practices can reduce costs, improve employees' morale and welfare and increase productivity (ISO-2010).

3. The third dimension of social responsibility is environmental responsibility that is one of the important aspects of social responsibility and a necessary condition for human survival and success. There is a close bond between environmental issues and human rights, community development and involvement and other pivotal topics of social responsibility. Corporates can improve their environmental performance by avoiding contamination, for example, preventing the spread of pollution in the air, restraining pollution discharge in water, stopping the production of solid and liquid wastes, preventing contamination of ground and soil, inhibiting the use or disposal of toxic and hazardous chemicals and other pollutions derived from organization's activities, products and services.
4. The fourth aspect of the social responsibility is the sense of responsibility on the institutions of the society. One of the responsibilities of business units towards the community is to pay a part of their earnings for educational, cultural and health facilities, because education is the foundation for any economic and social development and culture is an important part of the community and social identity. Promotion of education and the promotion and protection of culture have a positive impact on social development and cohesion (ISO, 2010).

To collect information on the social responsibility, the stock exchange activity reports of the corporates are used. According to these reports, corporates that comply the dimensions of social responsibility higher than the mean, are given number one and otherwise zero (Khajavi et al., 2011). Mean refers to those corporates that have at least two dimensions of the four dimensions of social responsibility, and are given number one and otherwise zero. To measure these variables, we use logistic regression.

Earnings Transparency: The transparency of the earnings is divided into two parts. The first part shows the earnings transparency for each industry separately that is called the industry part. The second part shows the earnings of transparency for all corporates, regardless of related industry that is called overall part (Barth et al., 2009).

$TRANS_{i,t} = TRANSI_{j,t} + TRANSIN_{p,t}$

TRANSIN: corporate's overall part

TRANSI: industry part

In fact, the earnings transparency is achieved through the sum of R^2 of each elements of earnings transparency (industry part and the corporate's overall part).

Industry Part:

$$RET_{i,j,t} = \alpha_0 + \alpha_1 E_{i,j,t} / P_{i,j,t-1} + \alpha_2 \Delta E_{i,j,t} / P_{i,j,t-1} + \varepsilon_{i,j,t}$$

E: earnings before unusual items and stopped operation

P: stock price at the beginning of year t (end of last year)

ΔE: change in earnings year t compared with the previous year (t-1)

ε: residual

RET: annual returns of firm i in industry j in year t

Corporate's overall part:

$$RET_{i,p,t} = \alpha_0 + \alpha_1 E_{i,p,t} / P_{i,p,t-1} + \alpha_2 \Delta E_{i,p,t} / P_{i,p,t-1} + \varepsilon_{i,p,t}$$

Control Variables:

Firm Size: It is measured by the natural logarithm of total assets.

Financial Leverage: It is the ratio of total liabilities book value to total assets book value, which reflects financial leverage of the corporate.

ROA: it is achieved by net income divided by total assets.

Market Value to Book Value: It is equal to the ratio of market value to book value. Market value of the corporate is equal to stock price of the corporate at the end of the year at corporate's stock number and book value of the corporate is equal to the book value of equity.

RESULTS

In order to evaluate and analyze the raw data, descriptive statistics of studied variables were calculated and presented in Table 1. This table contains information about the mean, median, standard deviation, minimum and maximum of data.

Table 1. Descriptive Statistics of Research Variables

Variable	Mean	Standard Deviation	Maximum	Minimum	Skewness	Elongation
Stock Price Crash Risk	0.166	0.156	0.623	-0.421	0.168	4.289
Earnings Transparency	-0.034	0.511	3.208	-1.540	2.189	12.761
Social Responsibility	0.423	0.494	1.000	0.000	0.313	1.098
Firm Size	13.492	1.520	18.817	8.028	0.408	5.170-
Financial Leverage	0.649	0.217	1.566	0.085	0.193	3.887
ROA	0.106	0.129	0.622	-0.327	0.583	4.662
Market Value to Book Value	1.488	1.654	8.675	-5.798	0.860	9.206

The study on descriptive results of research variables showed that the mean of dependent variable of stock price crash risk is equal to 0.166. In addition, the mean of the independent variables of earnings transparency and social responsibility are respectively -0.034 and 0.423. Due to the fact that the social responsibility variable is in the form of 0 and 1, so it can be concluded that the studied corporates do not have a high social responsibility because its value is less than 0.5.

First hypothesis

There is a significant relationship between social responsibility and the risk of stock prices crash of listed corporates in Tehran Stock Exchange.

The review on the t-statistic value of social responsibility variable (-2.677) shows at 5% error level it has a significant negative effect on the dependent variable (risk of stock prices falling). Therefore, it can be stated that hypothesis H_0 is rejected at the confidence level higher than 95%. This means that there is a significant inverse relationship between social responsibility and risk of stock prices falling (acceptance of the first hypothesis). According to the obtained results, it can be expressed that the more the corporate's social responsibility increases (decreases), the more the risk of stock prices crash in corporate will decrease (increase).

Table 2. Results of the first hypothesis testing (Dependent Variable: risk stock prices falling)

Variable	B	Standard Error	T-Statistic	Significance Level (Sig)
Intercept	0.165	0.083	1.985	0.048
Social Responsibility	-0.048	0.018	-2.677	0.008
Firm Size	0.002	0.006	0.324	1.746
Financial Leverage	-0.003	0.045	-0.067	0.947
ROA	0.063	0.076	0.827	0.409
Market Value to Book Value	-0.006	0.004	-1.392	0.165
Determination Coefficient	0.031		F-Statistic	(0.009) 2.896
Adjusted Determination Coefficient	0.021		Durbin-Watson	1.737

Second Hypothesis

There is a significant relationship between earnings transparency and the risk of stock prices crash of listed corporates in Tehran Stock Exchange.

The study on the t-statistic value of earnings transparency variable (-2.753) shows that at 5% error level it has a significant negative effect on the dependent variable (risk of stock prices falling). Therefore, it can be stated that hypothesis H_0 is rejected at the confidence level higher than 95%. This means that there is a significant inverse relationship between earnings transparency and risk of stock prices falling (acceptance of the second hypothesis). According to the obtained results, it can be expressed that the more the corporate's earnings transparency increases, the more the risk of stock prices crash in corporate will decrease. In addition, the review on the control variables of fitted model suggests that none of the control variables have a significant effect on the dependent variable.

Table 3. Results of the second hypothesis testing (Dependent Variable: risk stock prices falling)

Variable	B	Standard Error	T-Statistic	Significance Level (Sig)
Intercept	0.165	0.083	1.985	0.048
Earnings Transparency	-0.036	0.013	-2.753	0.006
Firm Size	0.002	0.006	0.324	0.746
Financial Leverage	-0.003	0.045	-0.067	0.947
ROA	0.063	0.076	0.827	0.409
Market Value to Book Value	-0.006	0.004	-1.392	0.165
Determination Coefficient	0.031		F-Statistic	(0.009) 2.896
Adjusted Determination Coefficient	0.021		Durbin-Watson	1.737

CONCLUSION

In this study, the relation of social responsibility and earnings transparency with the risk of stock prices crash in corporates listed on the Stock Exchange in Tehran was investigated. The first and second hypotheses of the research, regarding the relation of social responsibility, and earnings transparency and risk of stock prices crash were accepted in regression analysis and the correlations were inverse. This means that the more the corporate's social responsibility and earnings transparency increase (decrease), the more the risk of stock prices crash in corporate will decrease (increase). Earnings transparency improves the resource allocation and is directly concerned with efficiency and economic growth. Providing more transparent information leads to the reduction of information asymmetry, and thus reduction of the risk of stock prices crash. In addition, if corporates bring their social responsibility close to standards with high levels of transparency and involve in bad news less, the risk of stock price crash will come down..

Suggestions of Research Results

Given the results of research hypotheses, the following recommendations can be made in this connection:

- ✓ According to the results obtained from testing the first hypothesis stating that there is a significant relationship between social responsibility and the risk of future stock prices crash, investors and users of financial statements are suggested that consider the corporates' attention to social responsibilities in order to avoid a one-time negative adjustment of stock prices in Tehran Stock Exchange and prevent price bubbles in corporates' stocks.
- ✓ The results obtained from the second hypothesis can be used by financial statements users, capital market analysts and laws legislators. higher financial information transparency, which is the main goal of regulatory bodies, in particular the Securities and

Exchange Organization, can help to optimize resource allocation and eliminate all forms of information asymmetry and thereby reduce the stock prices falling.

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