

The Impact of the Enron Scandal on the Reputation of Corporate Social Responsibility Rating Agencies

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Abstract : KLD (Peter Kinder, Steve Lydenberg and Amy Domini) research & analytics is an independent intermediary of social performance information that adopts an investor-pay model. KLD rating agency does not have an explicit monitoring on the rated firm which suggests that KLD ratings may not include private informations. Moreover, the incapacity of KLD to predict accurately the extra-financial rating of Enron casts doubt on the reliability of KLD ratings. Therefore, we first investigate whether KLD ratings affect investors' perception by studying the effect of KLD rating changes on firms' financial performances. Second, we study the impact of the Enron scandal on investors' perception of KLD rating changes by comparing the effect of KLD rating changes on firms' financial performances before and after the failure of Enron. We propose an empirical study that relates a number of equally-weighted portfolios returns, excess stock returns and book-to-market ratio to different dimensions of KLD social responsibility ratings. We first find that over the last two decades KLD rating changes influence significantly and negatively stock returns and book-to-market ratio of rated firms. This finding suggests that a raise in corporate social responsibility rating lowers the firm's risk. Second, to assess the Enron scandal's effect on the perception of KLD ratings, we compare the effect of KLD rating changes before and after the Enron scandal. We find that after the Enron scandal this significant effect disappears. This finding supports the view that the Enron scandal annihilates the KLD's effect on Socially Responsible Investors. Therefore, our findings may question results of recent studies that use KLD ratings as a proxy for Corporate Social Responsibility behavior.

Keywords : KLD social rating agency, investors' perception, investment decision, financial performance

Conference Title : ICCSSR 2015 : International Conference on Corporate Strategy and Social Responsibility

Conference Location : Zurich, Switzerland

Conference Dates : July 29-30, 2015