The Role of Organizational Slacks during a Corporate Scandal: The Effects on Firm Value and Risk

by Dimitri Giacomo Simonin

Thesis submitted in fulfilment of the requirements for the degree of

Doctor of Philosophy

under the supervision of

Dr. Krithika Randhawa, UTS Business School, University of Technology Sydney
Dr. Jan Hohberger, ESADE Business School, Ramon Lull University
Dr. Gary Lilien, Smeal College of Business, Pennsylvania State University
Dr. Nico Schulenkorf, UTS Business School, University of Technology Sydney

University of Technology Sydney
UTS Business School, Faculty of Management

March 2022

Certificate of original authorship

I, Dimitri Giacomo Simonin declare that this thesis, is submitted in fulfilment of the requirements for the award of Doctor of Philosophy, in the Faculty of Management, UTS Business School at the University of Technology Sydney.

This thesis is wholly my own work unless otherwise referenced or acknowledged. In addition, I certify that all information sources and literature used are indicated in the thesis.

This document has not been submitted for qualifications at any other academic institution.

This research is supported by the Australian Government Research Training Program.

Production Note:
Signature removed prior to publication.

March 22nd, 2022

Acknowledgement

A doctoral thesis is often described as a solitary endeavour; however, the long list of people that follows definitely proves the opposite. This journey would not have been possible without their support.

First and foremost, I am deeply grateful for the continuous support, insight, and patience of my supervisory committee and mentors, Dr. Jan Hohberger, Dr. Gary L. Lilien, Dr. Krithika Randhawa, and Dr. Nico Schulenkorf, who believed in me. Dr. Jan Hohberger followed me from the first day of this journey to the delivery of my work without flinching, including three international moves, the Covid-19 pandemic, and an extraordinary experience as a visiting Ph.D. fellow at Esade Business School, which he arranged, providing an opportunity for me to grow professionally. He was always available when I needed his guidance. Thank you, Jan! A very special thanks to my idol of academics, Dr. Gary L. Lilien, for his invaluable and inspirational advice on my research, academic career, and life. From the initial steps of my journey, his deep experience and sage expertise have given me confidence in the present and future. Gary, I will always remember each of your wise advice! I want to thank my primary supervisor, Dr. Krithika Randhawa, for her great support, pushing me to the finish line by helping to bring the pieces of my work together, teaching me how to structure my arguments, and providing her efficiency and hardworking ethics. Her encouraging, thoughtful, and detailed feedback have been invaluable to me. I must also thank Dr. Nico Schulenkorf for his unwavering assistance starting from the second stage of my project. Without my supervisory panel's constant trust and occasional gentle prodding, this thesis would not have been completed. A particular thanks to Dr. Ljubomir Pupovac, my young mentor, who was always available to help, advise, and improve my work from the first to the last day of my journey. He took the important role of guiding and pushing me in my personal and professional choices through friendship and motivation. Also, I thank Dr. François Carrillat for his trust, support, and fellowship and for welcoming me to his doctoral program. Each of them contributed a unique and necessary aid.

Most importantly, I owe my deepest unending gratitude to my wife, Minsun Kim. You patiently listened to me rant and talk through my ideas. You morally supported me, encouraged, and motivated me to succeed at this personal goal. You not only proofread my work but also gave me enlightening advice on everything, entertained me and relaxed my stormy brain, and nourished me with delicious food. You walked next to me every day throughout the entire thesis process. I will never be able to express the depth of my gratitude for your love and the sacrifices you have made over the years – before, during, and probably after my Ph.D. Your unconditional support and belief in me are the reasons why I was able to reach this level of knowledge and achievement.

As the best gift ever received just before starting my journey, I want to deeply thank the person who has been next to me since the first day of his life, my son, Oliver Hansol Dimitri Kim. Even as a little boy, you had the patience and maturity to accept that we could not spend as much time together as we both wanted. You strongly supported me with all your heart by making beautiful drawings, lending your "doudouds," and preparing snacks to cheer me up. I am forever thankful for your unconditional love, support, and gentleness.

My doctoral journey would not have been the same without Dr. Alex Belli, Dr. Ekaterina Napolova, Dr. Manjunath Padigar, Dr. Ljubomir Pupovac, and Dr. Atya Zeb. I could not have imagined having better fellow mates and now friends. I am deeply thankful to you and your partners. Although we are scattered all around the world, you are always present to help with your knowledge, stimulating discussions, immense support, insightful advice, and strong friendship. It has been incredible luck to go through my journey with you at my side. You have given me the courage to pursue the next steps in my life. This A-team and your generosity will extend beyond this present journey.

Also, my family and old friends had to grudgingly learn to accept my separation from them and still gave me nothing but support and hope from far away, day after day, and have trusted me all these years. Without that hope and trust, this thesis would not have been possible.

My father and mother, Pietro Cuccuru and Jacqueline Simonin, brought boundless help and overwhelming generosity, both emotionally and financially, reminding me of the end goal. My brother, Yannis Cuccuru, acted as a wise advisor, entertainer, and complaints service provider; and my friends, Raphael Parvex, Julien Doret, and Elodie Magnin, reminded me of what is important in life and have always been supportive of my undertakings. Also, I want to give heartfelt thanks to my former professor and friend, Dr. Bernard Morard, for his trust and support since the launch of the project of becoming a Doctor of Philosophy; he made this journey possible to start.

I acknowledge the financial support from the University of Technology Sydney. I am thankful for the warm welcome of its scholars, especially Dr. Kyoung-He Yu, Dr. Peter Fleming, and Dr. Helena Li from the management department, and Dr. Hillbun (Dixon) Ho, Dr. Kyuseop Kwak, Dr. Paul Wang, Dr. Ingo Bentrott, and Dr. Bruce Perrott from the marketing department. I am also thankful to Dr. Deborah Edward for her support and for finding solutions to solve difficult situations, as well as the supportive work of the UTS's professional staff members: Michael Lee, Aki Plume, Courtney O'Regan, Ashleigh Hall, Reka Sadagopal, Kristy O'Hare, and Stella Ng, for their help and kindness.

I would like to extend my thanks to the Esade Business School and its scholars and staff who welcomed me for a part of my journey. They gave me the opportunity to learn from great scholars, meet wonderful Ph.D. peers, and work in a stimulating research environment.

I thank my proof-reader, who was able to turn my raw writing into a relatively sleek piece of work. He did an amazing job during the last days of my journey.

Conventional thesis

Table of contents

List of illustrations and tables

Figures

Tables

Abstract

Since the late 1990s, corporate scandals are on the rise. They have far-reaching consequences in the short and long terms and bring uncertainty to a firm's financial health, influencing investors' expectations about the future of the firm. Corporate scandals are inevitable, complex, and difficult to manage. Thus, managers continuously look for ways to protect their firms in such a situation. Yet, research on how firm resources are used in corporate scandals is sparse to date. In particular, the mitigating role of organizational slacks – resources held by firms to deal with unexpected events – remains underexamined. Drawing on the Resource-Based View and Behavioural Theory of the Firm, my thesis aims to determine whether organizational slacks mitigate corporate scandal's impacts on firm value and firm risk in the short and long terms. I posit that this mitigating effect depends on the type of organizational slacks, whether unabsorbed or absorbed, and on the timeframe of the strategic vision and firm's needs. I rely on the event study methodology to measure the financial impact of corporate scandals on firms with a unique cross-sectional dataset containing 257 worldwide environmental-, social-, and governance-related (ESG) corporate scandals of U.S.-listed firms from 2012 to 2015. Then, I analyse the distinctive mitigating roles of unabsorbed and absorbed slacks on firm values and firm risk using an ordinary least squares regression approach. My empirical analysis confirms that corporate scandals decrease short- and long-term firm values and increase firm risk. I also show that holding unabsorbed slacks helps firms through an inverted U-shape effect that mitigates the corporate scandal's impact on short-term firm value. This effect is linear on both long-term firm value and firm risk. Holding absorbed slacks mitigates the impact of a corporate scandal only on firm risk, and the mitigating effect is linear. My thesis contributes (1) to the organizational slacks literature by demonstrating the significant role of unabsorbed and absorbed slacks on short- and long-term firm values and firm risk in a corporate scandal's situation, and (2) to the research on corporate scandals by providing a richer conceptualization

of corporate scandal and strong evidence of its financial impact on firms, specific to the management literature. From a practical perspective, I reveal that managers can attenuate the negative effects of corporate scandals by building organizational slacks during shock-free periods and using them when facing corporate scandals. This implies that managers need to take into account short- and long-term perspectives when making strategic decisions on organizational slacks during corporate scandals.

Thesis summary

Since the end of the 1990s, corporate scandals have surfaced more frequently, partially because the information is easily accessible and can be instantly disseminated by the media. Local incidents quickly become global corporate scandals, intensifying in strength and reducing the time available for firms to implement a strategy to face such events. Corporate scandals relate to a variety of topics and take multiple forms, such as ethical misconducts, product recalls, ecological disasters, and accounting frauds. A classification based on environmental-, social-, and governance-related (ESG) implications is a pertinent way to categorize corporate scandals broadly. A corporate scandal is a corporate crisis that turns into a wide incident engaging intense and far-reaching public discussions about an assumed or proved violation of morality that damages the reputation of the firm and has a significant economic impact on the firm and society. Corporate scandals bring uncertainty to the firm's financial health and influence the investors' expectations of the future of the firm. Thus, to protect their firms, managers continuously look for ways to prevent, deal with, and recover from corporate scandals.

Researchers in the fields of finance, sociology, marketing, and management have analysed scandals using different approaches. While their approaches vary, most studies agree that scandals are inevitable, complex to manage, and arise from multiple causes. Yet, because research on corporate scandals is scattered across disciplines, the concepts and specificities to understand corporate scandals are not consolidated to date. Specifically, existing research on corporate scandals is limited in two aspects. First, few empirical studies examine the short- and long-term financial impacts of corporate scandals on firms. Second, the role of firm resources in a corporate scandal situation is under-researched. In particular, research has not examined the role of organizational slacks, defined as flexible resources held by firms to deal with unexpected events (e.g., Bourgeois III 1981; Cyert and March 1963), in situations of corporate scandal. Although organizational slacks are widely studied and well-known resources, no study

has examined if these resources can help firms to mitigate the effect of a corporate scandal. My thesis aims to fill these gaps.

As a primary step, I define the concept of corporate scandal and detail the notion of organizational slacks and its various mitigation roles. I also elaborate on corporate scandal's impact on firm value and firm risk and the magnitude of the effect in the short and long terms with precise measurements. After establishing the baseline effects of corporate scandals on short- and long-term firm values and firm risk, I focus on the main objectives of my thesis: (1) defining if organizational slacks have a role in protecting firms from the negative impact of corporate scandals and (2) if this protective role depends on the type of organizational slacks held by the firm. In particular, I aim to determine if organizational slacks mitigate corporate scandal's impact on firm value and firm risk in both short and long terms.

Drawing on the Resource-Based View and Behavioural Theory of the Firm, I suggest that holding organizational slacks helps to reduce the impact of corporate scandals on firms in both short and long terms; thus, organizational slacks influence the firm's stock market price – the short- and long-term firm values – positively and decrease the uncertainty in expected future cash-flows – the firm risk. Going further, I posit that these mitigating effects on firm value and firm risk vary with the types of organizational slacks, be they unabsorbed or absorbed slacks because they differ in their characteristics in terms of timeline availability and potential allocation process. Unabsorbed slacks are available in the short term and can be allocated without modifying the structure of the firm, while it takes more time to deploy absorbed slacks and generate internal organizational chances. Thus, it is important and relevant, both theoretically and practically, to understand how the different types of slacks may help in the short and long terms during a corporate scandal situation.

To investigate the mitigating role of unabsorbed and absorbed slacks on short- and long-term firm values and firm risk, I build a unique cross-sectional dataset of 257 worldwide ESG-related corporate scandals from 2012 to 2015 of 90 firms U.S.-publicly traded and listed in the S&P 500 index with their headquarters based in the U.S. Then, I examine the short- and long-term impacts of corporate scandals on firm value and firm risk. The short-term impact is measured on the days surrounding the corporate scandal. The long-term analysis is based on one year following the corporate scandal. Finally, I analyse the role of organizational slacks by their type, unabsorbed and absorbed, and how they moderate the impact of corporate scandals on short- and long-term firm values and firm risk. To do so, I use an ordinary least squares (OLS) regression approach with three different dependent variables: short-term and long-term firm values and firm risk.

The results of the baseline effect confirm that a corporate scandal decreases short- and long-term firm values and increases firm risk. The regression analysis' results reveal that holding organizational slacks mitigates the corporate scandal's negative impact on short- and long-term firm values and risk. More specifically, unabsorbed and absorbed slacks mitigate the corporate scandal's impact on the firm value and risk differently depending on their timeframes. On the one hand, holding unabsorbed slacks has a curvilinear impact on firm value in the short term; the significant effects are linear on long-term firm value and firm risk. On the other hand, holding absorbed slacks decreases significantly firm risk.

From a theoretical perspective, my thesis contributes to the literature on corporate scandals and organizational slacks. First, my findings demonstrate the significant role of organizational slacks in protecting firms during corporate scandals. By distinguishing between unabsorbed and absorbed slacks, and their use in the short and long terms, I establish the importance of holding organizational slacks to protect both the short- and long-term firm values and firm risk from the shock of a corporate scandal. These findings help define the respective roles of both types of slacks to highlight their buffering and enabling capacities in the context of corporate scandals.

I thus contribute to our limited understanding of mechanisms on the relationship between types of organizational slacks and the complex structure of corporate scandals.

Moreover, I extend the methodological and empirical scope of research on corporate scandals, allowing for robust results in both short- and long-term timeframes by building a unique cross-sectional dataset with corporate scandals precisely dated on multiple types of corporate scandals from multiple industries.

From a managerial perspective, my findings indicate that managers can attenuate the negative effects of a corporate scandal on their firm by increasing the level of organizational slacks during shock-free periods and using them when facing such events. Also, I find that managers need to consider both the short and long terms equally and adapt the use of each type of organizational slacks according to the targeted timeframe. Overall, my thesis urges managers to consider the firm value and risk separately and hold an optimal level of organizational slacks towards a situation of corporate scandal.

Finally, given the extent to which firms suffer from the shock of corporate scandals, the economic perspective should not be ignored. As my results show, with an average of 0.3 percent of the decrease in short-term firm value on the day of the corporate scandal and 7.2 percent in a one-year post window, corporate scandals can have extreme financial impacts on firms. Holding organizational slacks helps the firm restrain an increase in firm risk caused by a corporate scandal, thus avoiding long-lasting consequences. These resources can help maintain competitive advantage and growth even after the corporate scandal ends. However, from an economic point of view, holding absorbed slacks might not be the optimal solution to face a corporate scandal. Based on my empirical results and extensive investigation of both corporate scandals and organizational slacks literature streams, I argue that the direct and indirect costs of absorbed slacks might not worsen their significant mitigating effect on firm risk.