



CAMPUS LIFE

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Living Up to Your Codes? Corporate Codes of Ethics and the Implied Cost of Capital

ABSTRACT:

Is a code of ethics mere window-dressing or a useful ethical guidance to constrain opportunistic behaviors? Using a novel dataset that records the comprehensiveness and implementation of a code of ethics of the S&P500 firms between the period of 2004 and 2012, we demonstrate that firms with a higher quality code of ethics have a significantly lower implied cost of capital. Consistent with the theoretical predictions of Bicchieri's (2006) and Davidson and Stevens (2012) that a high-quality code of ethics can activate social norms that help control opportunistic behaviors, we find that firms with a higher quality code of ethics also have a lower litigation risk. Using lawsuits as an exogenous shock, we conduct an event study and investigate the impact of the shock on the quality of a code of ethics and the implied cost of capital. Our findings suggest that after experiencing a significant increase in the implied cost of capital in the lawsuit years, firms seek to improve the implementation procedures of their codes of ethics and such improvement is followed by a significant reduction in the implied cost of capital in the subsequent years.

Campus San Giobbe, aula volpato

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