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What Corporate Social Responsibility Activities are Valued by the Market?

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ABSTRACT. Corporate management is torn between either focusing solely on the interests of stockholders (the neo-classical view) or taking into account the interests of a wide spectrum of stakeholders (the stakeholder theory view). Of course, there need be no conflict where taking the wider view is also consistent with maximising stockholder wealth. In this paper, we examine the extent to which a conflict actually exists by examining the relationship between a company's positive (strengths) and negative (concerns) corporate social responsibility (CSR) activities and equity performance. In general, we find little evidence to suggest that managers taking a wider stakeholder perspective will jeopardise the interest of its stockholders. However, our findings do suggest that the market is not only influenced by the independent CSR activities, but also the totality of these activities and that the facets that they value do vary over time. It seems that most recently, the market has valued most firms that satisfied minimum requirements in the areas of diversity and environmental protection but were most proactive in the area of employee-relations.

KEYWORDS: corporate social responsibility, corporate performance, shareholder value, value-based management

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The neo-classical economists' view of the role of professional management within a company is that their decisions should be solely predicated on the objective of maximising the corporation's long-term market value and so the wealth of the company's owners. In contrast, stakeholder theory suggests that managements' concern should extend to a much wider spectrum of stakeholders (e.g., employees, customers, suppliers and the general community) whose interests should all be taken into account in the decision processes of management. There is clearly the potential for conflict between these two views in those instances where maximising the wealth of owners is not the natural outcome of a process where the decisions by management are influenced by the interests of a broad spectrum of stakeholders.

The focus of this paper is on examining the extent of this potential conflict faced by management. In the first section of the paper, we will consider the foundation of this potential conflict in more detail, highlighting the need to resolve the extent of any relationship that might exist between management using the company's resources on what is best described as corporate social responsibility (CSR)

activities and the consequential impact of these activities on corporate performance. This is an issue that has been the subject of much investigation over the last 30+ years and we will provide a summary of some of this literature in "Corporate social responsibility and corporate performance" section. The question that we want to answer is just what types of CSR activities, if any, are rewarded by improved market performance. In other words, we want to isolate the areas where there is no apparent conflict between neo-classical economists and stakeholder theory. We outline the data and method that we employ in this analysis in "Data and method" section and report and discuss our findings in "The findings" section. We wind up the paper in "Summary and conclusions" section where we summarise the major implications of our findings and present some thoughts for future research.

Neo-classical economics and stakeholder theory

The starting point for this paper as it has been for many preceding papers on similar topics, is the famous quote from Milton Friedman (1970) who wrote that "there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception and fraud". Friedman argued that the management of a public company are agents for its shareholders and it is their sole responsibility to act in the shareholders' interests, which suggest that management has no right to expropriate shareholder wealth to the benefit of other parties. Further, he suggests that it is the role of the Government to consider the potential impact of companies on other stakeholders and to take these into account when setting the rules (e.g., taxation, regulation) that govern the behaviour of companies.

In contrast, the stakeholder theory of the firm (Freeman, 1984) widens the focus of management beyond using the resources of the companies for the sole benefit of shareholders to using these resources to the benefit of a much wider group of stakeholders. As Donaldson and Preston (1995) stated, stakeholder theory posits a model of the firm in which "all persons or groups with legitimate interests in participating in an enterprise do so to obtain benefits, and there is no prima facie priority of one set of interests and benefits over another". It goes beyond the simple idea that organisations have many different stakeholders to the more fundamental questions of what interest should drive the companies and in whose interest the companies should operate. Stakeholder theory gives rise to the concept that companies have a CSR to take into consideration the impact of its activities on all of its constituents.[1] For example, the company may aim to benefit the community by such activities as supporting the construction of a theatre complex or reducing the pollution in the river systems; to benefit its employees by providing childcare facilities or by including a performance-based bonus scheme in its salaries packages; to benefit its clients by producing cheaper and/or safer products.

One might ask where stakeholder theory actually leaves management given that it suggests that they have to take into account the sometimes potentially conflicting interests of a wide and diverse spectrum of stakeholders when deciding how best to employ corporation's resources. As Jensen (2001) points out, under Stakeholder Theory management is given no direction as to how to differentiate between the interests of the different stakeholders and so there is no *best* outcome and so no way of judging manager performance. In effect, the boundaries of legitimate stakeholders are not defined nor are the weights to be attached to the interests of each stakeholder and so the objective function on which management is to base their decisions is ill-defined.[2] De George (1990) provides an insight to the possible resolution of this conflict affirming that "A stakeholder analysis does not preclude the interests of the shareholders overriding the interests of the other stakeholders affected but it ensures that all affected will be considered". Jensen (2001) brings the original idea of De George a step further in proposing the Enlightened Stakeholder Theory, which recognises that a single-minded approach to realise maximum value for shareholders to the detriment of various stakeholder groups is unlikely to succeed. For example, paying minimum salaries to employees and requiring them to work in very poor conditions is likely to have a negative effect on productivity which may more than offset any cost-savings and so actually

reduce the value of the firm. Indeed the capacity of a firm to generate sustainable wealth over time, and hence its long-term value, is determined by its relationships with critical stakeholders (Post et al., 2002). This suggests that consistent with stakeholder theory, management has to consider the impact of its decisions on a broad spectrum of stakeholders but, consistent with the neo-classical view, to ultimately evaluate all of these decisions on the basis of their impact on the market value of the company.

Putting a corporate finance interpretation to the enlightened stakeholder theory proposed by Jensen, what he is suggesting can be interpreted as saying that management should still apply net present value analysis to every decision. In other words, no investment or financing should be undertaken by the firm unless the present value of the associated incremental benefits exceeds the present value of the incremental costs. In this framework, it is highly possible that investment in some CSR activities will have a positive impact on the value of the firm and thus be justified within Jensen's enhanced stakeholder theory.[3] For example, the provision of childcare facilities for staff will come at a cost to the company which may be more than offset by improvements in employee productivity.

Indeed, there are various ways in which expenditures on CSR activities may translate into increases in value for the company:

- Activities that result in an immediate cost-saving which will flow through to increased profitability and supposedly an increase in the company's market valuation. An example of this is a company which decides to become more energy efficient which will not only have a positive impact on the environment, but will also reduce its costs and so will boost it profitability and flow through to a higher market valuation.
- Other activities that bring reputational benefits (goodwill) to the company which increase both profitability and market valuation in the longer-term. Examples of this could include decisions to improve product quality or donate to medical research, both of which might have an initial detrimental impact on profitability but contribute to the improvement in the company's market image which may translate to increases in both profitability and market valuation in the longer-term.
- Other activities that dissuade future action by Government and other regulatory bodies which might impose significant costs on the company. An example of this might be taking action to voluntarily control pollution emission which may again come at an initial cost but might dissuade government from introducing regulations and/or taxes on the company which may have imposed even greater costs on the company and so resulted in even a greater erosion in the company's market value.

What the above examples emphasise is that management in companies already have strong incentives to consider the interests of a wide spectrum of stakeholders in the pursuit of a goal of value maximisation. As a consequence the extent of the actual conflicts that exist for management drawn between the demands placed on them by shareholders and those placed by a wider circle of stakeholders might be somewhat limited. Where no conflict exists, then there is likely to be a market solution, which ensures that the interests of that particular stakeholder are protected. Where there is a conflict, then management might compromise the interests of shareholders by taking account of those of other stakeholders or may choose not to do so which leaves the option for interested parties to lobby the government to change the rules of the game to protect one or more stakeholder groups.

In the next section of the paper, we consider the existing evidence on the relationship between CSR activities and financial and market performance as a precursor to conducting our own analysis.

Corporate social responsibility and corporate performance

We are interested in the association between CSR and corporate performance because of its implications for corporate management who potentially face a conflict because of the narrow definition of their role which stems from the neo-classical economics' view and that which stems from stakeholder theory.

The existing literature would provide support for all possible outcomes in terms of the direction of this relationship:

(i) The neo-classical view suggests that any expenditure on CSR activities will put the company at a competitive disadvantage and so result in a *negative* relationship between these activities and market performance (Aupperle et al., 1985)
(ii) Those that say that there are so many other more important events that impact on financial and market performance resulting in there being *no observable* relationship between the extent of a company's CSR activities and the performance realised by the company (Ullman, 1985)
(iii) Others that argue that there will be a *positive* relationship between CSR activities and corporate performance for reasons such that the costs are small while the benefits as outlined in the previous section are potentially large (Moskowitz, 1972) and/or that those managers who embark on such activities are just better managers who will be able to generate higher profitability and so better market performance (Alexander and Buchholz, 1982).

The fact that there is such an obvious disagreement on *a priori* grounds as to the relationship between CSR activities and corporate performance has been the stimulus for the numerous empirical studies that have been reported over the last 30+ years. Perhaps not surprisingly, but maybe disappointingly, the conflicting findings has meant that the empiricists have not been able to resolve the dispute within the theoreticians. Griffin and Mahon (1997) review 51 papers on this topic and reported that 33 reported a positive relationship, nine reported no relationship while 20 reported a negative relationship.[4] This lead them to conclude that "even though there is hope in the large number of studies that have a positive relationship, academics and practitioners alike should be concerned with the variability and inconsistency in these results" and they went on to report some reasons for these inconsistencies and how the research design could be improved in the future. Roman et al. (1999) reworked and extended the Griffin and Mahon paper questioning their categorisation of the results of a number of papers. Roman et al. categorised 33 studies finding a positive relationship between CSR and corporate performance, 14 that failed to find any relationship and only five that found a negative relationship. Overall, their findings are much more supportive of a positive relationship between CSR and performance than were the findings in Griffin and Mahon.

Oritzky et al. (2003) argued that the "vote counting"' used by Griffin and Mahon and Roman et al is flawed. They proposed meta-analysis as the appropriate way of aggregating the finding across a large number of studies. In particular they claim that meta-analysis will enable them to overcome the problems associated with sampling errors and measurement errors which might be the cause of the variation in the findings of previous writers. Based on the meta-analysis that they conducted using 61 prior studies, they conclude "that (1) across studies CSP (corporate social performance) is positively correlated with CFP (corporate financial performance), (2) the relationship tends to be bidirectional and simultaneous, (3) reputation appears to be an important mediator of the relationship...". The problem with their analysis is that there are approximately 30 different dependent variables (i.e., measures of financial performance) utilised across the 61 studies and further there is also great variability in the measures of CSP utilised. As Griffin and Mahon (1997) had already pointed out "the use by various researchers of a wide range of multiple measures for both CSP and CFP with little or no replications or checks for validity and reliability, suggests the need to focus of a few, key CSP and CFP research measures to increase the internal validity rather than the generalizability." We would suggest that this lack of homogeneity brings into question the interpretation that can be placed on the findings in Oritzky et al study. The reason for why we have failed to achieve closure on the direction of the relationship between CSR and corporate performance has been the subject of consideration in a number of papers.[5] Suggestions include (i) the lack of a strong conceptual foundation, (ii) the lack of appropriate measures of the extent of a company's CSR activities, (iii) the lack of a sufficient sample size, and (iv) the lack of methodological rigour. We suggest that Enlightened Stakeholder Theory provides the conceptual rigour to support the analysis undertaken in this study. The

use of the KLD CSR ratings addresses the second and third points in that this database is acknowledged as the best database available on CSR activities[6] and provides more than 10 years of data on more than 500 US companies. The introduction in our study of several factors as control variables that have previously found to be correlated with corporate financial performance addresses the major methodological concern.

Perhaps the most important feature of our methodology is that we do not focus on a total CSR score for each company but rather analyse five distinct CSR activities separately. Further, we examine both a strengths and a concerns score for each activity where strengths can be taken to broadly mean the extent that a company exceeds legal requirements and/or minimum community standards with respect to that activity and concerns can be taken to broadly mean the extent that a company falls short of legal requirements and/or minimum community standards with respect to that activity. We suggest that examining the strengths and concerns for separate CSR activities will provide us with the most useful insights into which are valued by market participants. For example, Frooman (1997) undertook a meta-analysis and concluded that companies engaging in socially irresponsible and illicit behaviour suffered in terms of their market valuation but that there was insufficient evidence to determine whether companies that behaved in a positive way were rewarded in terms of their market valuation. These findings were confirmed by Johnson (2003) who found that companies that act in an illegal or irresponsible manner are punished by investors. However, he concluded that there is no evidence to suggest that companies that go beyond legal and community standards are rewarded by way of a higher market valuation.

In the next section, we provide more details on the data and method employed in this study while the results are reported and discussed in "The findings" section.

Data and method

As discussed in "Corporate social responsibility and corporate performance" section, the neo-classical economists' owner-focussed definition of the appropriate objective for a corporation and the much broader definition stemming from Stakeholder Theory are only in conflict in those situations where corporate management by giving consideration to the interests of one or more stakeholders does so at the expense of the wealth of the company's owners. As a consequence, no conflict exists where expenditures on CSR activities have either a neutral or a positive impact on the company's market valuation. Given the focus of this paper on the potential conflict for management following the stakeholder theory view, the obvious analysis is to determine the impact of CSR activities on the market value of a corporation's stock.

This gives clear direction that market returns should be one dependent variable we should consider in our study in preference to any accounting measure of financial performance, as it is market returns that directly impact on owner wealth. It is interesting to note that market returns were a focus in less than 20% of the studies evaluated by Oritzky et al. (2003) indicating that prior studies have largely concentrated on the relationship between CSR and accounting measures of performance. Although a positive association between CSR activities and financial performance and a negative association between CSR activities and risk[7] may provide a strong case for expecting that CSR activities to be positively associated with market returns, there is no guarantee of this as market prices are based on expectations relating to the future rather than current events. For this reason, we also consider as dependent variables valuation multiples such as market-to-book and price-to-earnings as they encapsulate the market expectations relating to both future earnings and the risks associated with those earnings.

Data

The CSR data used in this study was obtained from KLD Research & Analytics, Inc., (KLD) which provides social issue ratings across a range of corporate activities that impact on the various stakeholders. Since the coverage of the database is limited to the US market, our analysis is confined to the American corporate system. We utilise the KLD ratings issued during the period from 1991 to 2003 for US companies included in the S&P500 index.

KLD provides ratings under seven headings but we restrict our analysis to the following five activities for which KLD provides both a positive ("strengths") and negative ("concerns") score:[8]

1. *Community* (COMMUNITY) which on the positive side (STRENGTHS) measures various contributions that the company makes to the community such as charitable contributions and support for the disadvantaged; while on the negative side (CONCERNS), it measures activities that are judged to have had a negative economic impact on the community and/or possibly mobilised community opposition.
2. *Diversity* (DIVERSITY) which on the positive side measures the activities of the company in such areas as providing employment opportunities for minorities and providing working conditions that meet the special needs of minorities; while on the negative side it measures such things as the non-representation of minorities in senior positions within the company and major controversies on affirmative action issues.
3. *Employee Relations* (EMPLOYEE) whose positive employee relations are indicated by such practices as strong worker involvement within the company, generous profit sharing across the majority of employees, good retirement benefits and/or a good safety record; while on the negative side the company might have bad unions relations, a poor safety record and/or a poorly funded pension plan.
4. *Environment* (ENVIRONMENT) where a company obtains a positive score as a results of environmentally sound practices such as pollution prevention, and recycling; while the company will obtain a negative score for practices such as producing hazardous waste and/or environmentally unfriendly products.
5. *Product* (PRODUCT) which on the positive side measures activities such as high product quality, high innovation and the development of products to meet the special needs of the disadvantaged; while on the negative side, the company will be graded for practices as low product safety, controversies over how it advertises its products and other product-related community concerns.

In summary, the ratings supplied by KLD provide a measure of corporate activities which are demonstrative of either strengths or concerns with respect to a diverse set of CSR activities that have the potential to impact on a wide range of stakeholders including employees, customers and the community at large. In order to assist in interpreting our findings, we suggest that it is appropriate to regard a strength (concern) score as being indicative of the extent to which a company exceeds (falls short of) legal requirements and minimum community standards with respect to each CSR activity considered.

A significant positive (negative) relationship between a strength (concern) score and future stocks returns and/or a valuation multiple is a clear indication that there is no conflict between a company pursuing a particular type of CSR activity and the maximisation of owner wealth. Hence, we are interested in the sign of the relationship between the KLD scores for both strengths (STRENGTHS) or concerns (CONCERNS) for each of the five activities being evaluated with our dependent variables, future stock returns and valuation multiples. However, we would not be surprised to find instances where the coefficients provide evidence inconsistent with owner wealth maximisation as the KLD criteria were not drawn up with any specific consideration being given to their association with shareholder wealth. For example, donations and other charitable activities which are described as community strengths (COMMUNITY_STRENGTHS) are unlikely to be undertaken by management with the expectation that they will have a positive impact on owner wealth (Seifert et al., 2004). Therefore we would not be surprised to find evidence of some activities that would seem to be at variance with owner wealth maximisation, perhaps reflecting that the KLD criteria were not drawn up with this function in mind.

KLD awards a one to each company that satisfies each criterion and a zero to those that fail to satisfy the criterion. We should first mention that the number criteria on which KLD scores a company varies across the different items. For example, there are seven criteria on which a company is scored for Community strengths and three criteria on which they are scored for Community concerns. The maximum that a company can obtain for each activity are set out in Table I. *One option* for using

TABLE I

Maximum score for each CSR activity

Activity	Maximum score	
	STRENGTHS	CONCERNS
COMMUNITY	7	4
DIVERSITY	8	3
EMPLOYEE RELATIONS	6	5
ENVIRONMENT	7	7
PRODUCT	4	4

the KLD scores in our analysis is simply to award each company a score equal to the number of criteria that it satisfies for each activity. For example, if a company satisfies four of the seven Community strength criteria, then it will be awarded a COMMUNITY_STRENGTHS score of four. An analysis of the distribution of these scores by activities identified wide variations and suggested to us a *second option* for using the KLD scores in our analysis. This involved using a three-point scale for each activity where a 0 indicated that they satisfied none of the KLD criteria, a 1 indicated that they satisfied a small number of the criteria, while a 2 indicated that the company satisfied most criteria.[9] However, in those cases where there were a small number of criteria or very few companies satisfied many criteria, we only used a two-point scale indicating those companies that either did or did not satisfy any of the criteria. The *third option* to investigate for using the KLD scores was to evaluate whether a company's score for a particular criteria changed from 1 year to the next. There were three possible outcomes here: the scores increases (+1), the score stays the same (0), the score decreases (−1). This third option allowed us to analyse how changes in KLD scores impact the financial performance of the firm.

We include these CSR variables as either raw scores (in the case of option one) or dummy variables (in the case of options two and three) where the dependent variable are either the excess return on a company's shares or a valuation multiple (either price-to-book or price-earnings). The returns on each company's shares were obtained from DataStream and then the excess returns were calculated by deducting from each stock's return, the market weighted return for our universe of stocks. The two valuation multiples, market-to-book and price-to-earnings, were also obtained from DataStream.

We also included in our analysis a number of control variables chosen on the basis that they had been identified in previous studies to explain some of the variation of returns across stocks. The actual control variables utilised were:[10]

- The log of the company's market capitalisation as measured by the market value of the company's shares (Banz, 1981).
- The company's market-to-book ratio as measured by dividing the market value of the company's shares by the book value of the company's ordinary shares (Lakonishok et al., 1994).
- The momentum in the company's stock as measured by the return over the previous 6-months (Jegadeesh and Titman, 2001).
- The company's financial leverage as measured by its debt-to-total assets ratio (Fama and French, 1993).

These control variables were determined as at the end of March each year using data obtained from DataStream.

Method

In the years 1991–2001, the KLD social ratings for each company became available in August while in 2002 and 2003, they became available as at the end of December. By far the most important implication for the analysis flows from the interpretation that we place on the KLD ratings. It is important to note that we do not regard the release of the ratings by KLD to be the source of new information to the market because these ratings are based on public information relating to events that have already occurred. As such, the KLD ratings provide a convenient way of providing confirmatory information as to how active a company is in a particular area of CSR activity. Most importantly, the ratings allow us to categorise a company's performance on the basis of various types of CSR activities with the proposition being that these activities will have long-term implications for

the company in terms of the performance of its stock. In order to analyse this and take account of the possibility of the impact of these activities to take time to be reflected in the company's valuation, we evaluate five dependent variables: the excess return over the year commencing at the beginning of April each year (one-year returns), the excess return over the two-year period commencing at the beginning of April each year (two-year returns), and the excess return over three-year period commencing at the beginning of April each year (three-year returns), the market-to-book ratio (MTBV) and the price-to-earnings ratio (PE).

To summarise, each year the excess returns and the valuation multiples are calculated as from the beginning of April, the control variables are determined as at the end of March and the CSR variable become available in August as from 1991 to 2001 and as at the end of December in 2002 and 2003.

Our data set for each year consists of all stocks included in the S&P500 index for which we have all of the required data. We also delete from our sample all stocks that have a negative book value and in a few cases those stocks that have a very small positive book value which results in extreme market-to-book ratios. Finally, we exclude stocks each year which have annual returns and valuation multiples that lay more than three standard deviations from the mean. The number of stocks that remain in our sample each year are reported in Table II.

The regression equation that is evaluated when using the excess returns as the dependent variable is set out below:

$$r_{it} = \alpha_t + \sum_{j=1}^{n} \alpha_t^j \mathrm{CV}_{it}^j + \sum_{p=1}^{m} \alpha_t^p \, \mathrm{CSR}_{it}^p + \varepsilon_{it} \quad (1)$$

TABLE II

Number of stocks in data set each year

Year	1991	1992	1993	1994	1995	1996	1997
Number	340	351	347	357	371	369	372
Year	1998	1999	2000	2001	2002	2003	
Number	380	389	386	399	417	420	

where r_{it} is the excess return on stock i between the period t and $t + 1$, CV_{it}^j is the control viable j for stocks i at time t, CSR_{it}^p is the CSR classification for activity p for stock i at time t and ϵ_{it} is the error term for stock i at time t.

A number of other points relevant to our analysis are briefly summarised below:

- The data for each of the 13 years is pooled in order to obtain our estimate of the coefficients for the explanatory variables.
- We also divide the sample up into two periods (1991–1997 and 1998–2003) and repeat the analysis to see if the coefficients on the explanatory variables change significantly over time.
- We examine each of the strengths and concerns associated with the five CSR activities independently in order to determine the impact of these activities when judged in isolation.
- We repeat the analysis for two composite scores across all criteria which we suggest provides a good indication of the impact on markets of having either a good, bad, or indifferent CSR reputation.

In each case we start with the regression similar to that outlined in equation 1 which includes all of the control and CSR variables independently. We then examine both the direction and significance of the sign attached to each CSR variable in order to gain insights into its market impact. Where we use dummy variables (options two and three), we use the Wald test on grouping of the CSR variables to test for significance (e.g., we evaluate the impact one-by-one of a combination of all of the variables pertaining to community strengths, pertaining to community concerns, pertaining to diversity strengths, and so on). This analysis is conducted first over the total period of our sample and then over the two sub-periods. The same analysis is repeated for the entire sample period for the composite scores across all criteria. Finally much of the same analysis is repeated where the two valuation multiples replace excess returns as the dependent variables.

The results of this analysis are reported and discussed in the next section.

The findings

The objective of the empirical analysis is to determine the relationship between the various CSR activities (both strengths and concerns) and their market valuation in order to gain insights into their eventual impact on owner wealth. The method that we employ is outlined in the previous section and we will now report and discuss our findings.

Analysis of independent CSR activities over entire sample period

Using equation (1) as the basis for our analysis, we determined the optimum model for each of the five dependent variables (returns over the next one year, two years and three years, market-to-book and price-to-earnings) by pooling the data over our whole sample period. Subsequently we divide out sample up into two periods in order to be able to see whether there have been any significant changes in the relationships that we are examining.

Control variables

The first results that we report in Table III are those where we only include the control variables to explain the variability of the annual excess returns earned by stocks over our complete sample period. In summary, our findings confirm that these control variables are all highly significant and with the expected sign which confirms both the findings from previous studies and the desirability of including them as control variables in this study.

TABLE III

Coefficient attached to the control variables: one-year excess returns (1991–2003)

Variable	Coefficient	*p*-Value
Constant	0.2438	0.0000
MTBV	−0.0067	0.0003
Momentum	0.1500	0.0000
Gearing	0.0005	0.0031
LOGMV	−0.0263	0.0000
Adjusted R^2	2.76%	

Dependent variable: excess return over next 12 months (1991–2003)

In Table IV, we report the model that best explains the variability in the 12-month returns over the period of our sample. In this case, we have completed the analysis using the first two of the options previously discussed for utilising the KLD ratings. A review of the table indicates that the two options yield an identical finding which is a trend that is maintained over the remainder of our analysis.[11] Therefore, in the future we will only report the findings obtained from using option one.

Of the five CSR activities evaluated (with strength and concern scores for each), the only two that proved to have a significant relationship with returns realised over the next 12-months was the strength score for diversity and the concern score for the environment. The positive relationship between diversity strengths and future returns is as expected indicating that the market rewards a company for being proactive in its diversity activities (e.g., employing and promoting minorities, providing benefits that address work/family concerns). The negative relationship between environmental concerns and future stock returns is also as one might expect and indicates that the market takes a negative view of those companies whose activities are inconsistent with regulations and environmental norms with respect to environmental protection (e.g., produces toxic chemicals and hazardous waste, does not comply with environmental regulations).

We identified eight activities (four strengths and four concerns) which have no discernible impact on future stock returns and so shareholder wealth. To a certain extent this is good news for managers in terms of suggesting that there is no conflict between managing the firm in the interests of the shareholders alone or taking account of the interests of a wider spectrum of stakeholders. On the other hand, it does not provide an incentive for managers following the narrower neo-classical objective for the firm to pay much attention to the interests of a wider spectrum of stakeholders with respect to the majority of CSR activities that we are considering in this paper.

TABLE IV

Coefficients of significant CSR variables: one-year excess returns (1991–2003)

Variable	Coefficient	p-Value	Joint test p-value
Option one: use aggregated KLD ratings			
DIVERSITY_STRENGTHS	0.0205	0.0001	
ENVIRONMENT_CONCERNS	−0.0180	0.0019	
Adjusted R^2	2.34%		
Option two: use dummy variables based on KLD ratings			
DIVERSITY_STRENGTHS_2	0.0398	0.0057	0.0002
DIVERSITY_STRENGTHS_3	0.0606	0.0001	
ENVIRONMENT_CONCERNS_2	−0.0226	0.1094	0.0380
ENVIRONMENT_CONCERNS_3	−0.0510	0.0263	
Adjusted R^2	2.30%		

Dependent variable: excess return over next one, two and three years (1991–2003)

One potential reason for why we identify so few significant relationships when considering there impact on 12-month excess returns is that the market is slow in recognising the benefits associated with CSR (e.g., it takes time a company to build up goodwill as a result of these activities). If this is the case, then, we might see more significance associated with the CSR variables when we extend our dependent variable to be stocks returns over longer time periods.

We report in Table V, the significant CSR variables for each of the three independent variables (i.e., one-, two- and three-year excess returns). We do find that the number of significant CSR variables increases where excess returns are measured over periods greater than 12 months which is consistent with the market taking some time to either reward or punish a company for these activities. Indeed, the CSR activities prove to be significant in explaining both two-year and three-year excess returns in six of the ten cases examined. In three of these six cases the sign on the relationship is as we might expect. Those companies that fail to take account of diversity issues and/or fail to perform with respect to environmental concerns are punished by the market while those that follow good employment practices are rewarded in the market. This sends a clear message to management as to the CSR activities for which they will be rewarded and so where they would be well-advised to take account of the interests of a wide spectrum of stakeholders.

What might be regarded as somewhat surprising is that there are three instances where the sign attached to the CSR activity is the opposite to what one would expect if that activity had a positive impact on the market value of the firm. It would appear that a company is punished in the market for being proactive in their environmental practices while it is rewarded in the market for violating both community and product concerns as measured by the KLD ratings. The finding that environmental strengths have a negative impact on market performance combined with the previously discussed finding that environment concerns also have a negative impact on market valuations suggest that market participants recognise the need to meet regulatory requirements in this area and so not subject a company to potential litigation but punish those companies that expend corporate resources on environmental activities that go beyond meeting minimum requirements. The market seems to endorse the idea that profit generation from investments in cleaner technologies might make business sense in certain circumstances, but not in all. It is management's duty to identify the circumstances favouring the generation of both public benefit and corporate profits.

There would appear to be no logical explanation for why the market would reward a company for

TABLE V

Coefficients of significant CSR variables: one-, two- and three -year excess returns (1991–2003)

Variable	One-year returns		Two-year returns		Three-year returns	
	Coefficient	*p*-Value	Coefficient	*p*-Value	Coefficient	*p*-Value
COMMUNITY_CONCERNS			0.1053	0.0009	0.1785	0.0000
COMMUNITY_STRENGTHS						
DIVERSITY_CONCERNS			−0.0673	0.0018	−0.1010	0.0007
DIVERSITY_STRENGTHS	0.0205	0.0001				
EMPLOYEE_CONCERNS						
EMPLOYEE_STRENGTHS			0.0370	0.0022	0.0447	0.0070
ENVIRONMENT_CONCERNS	−0.0180	0.0019	−0.0414	0.0000	−0.0637	0.0000
ENVIRONMENT_STRENGTHS			−0.0458	0.0080	−0.0454	*0.0566*
PRODUCT_CONCERNS			0.0345	0.0079	0.0564	0.0015
PRODUCT_STRENGTHS						
Adjusted R^2	2.34%		2.28%		2.14%	

being involved in controversial issues relating to both its products and its dealing with the community. We would suggest that the public nature of the poor performance in these two areas possibly provides the explanation for these findings. As noted previously, the KLD ratings reflect events that have already occurred and in the case of both products and community concerns typically they are events that became public knowledge well in advance of the release of the KLD ratings. Given this scenario, a possible explanation for our findings is that there has been an overreaction to the news around the time the relevant event(s) became public knowledge and what we are observing is the market correction to this initial overreaction.[12] This explanation gains some support from the fact that the correction is only observed in the two-year and three-year returns and so possibly reflects a slow market response to an initial market overreaction.[13]

The major focus of this paper is on whether there is any conflict between a manager acting in the interests of a wide spectrum of stakeholders and the maximisation of shareholder wealth. Perhaps the only clear evidence of such a conflict is that the market does not take kindly to those companies that over invest on environmental protection. In other areas, a company might expect that CSR activities will either have a positive or neutral impact on its market valuation. We would summarise our main findings to date as follows:

- With the exception of CSR activities that are best described as events (e.g., announcements of litigation or fines), the market is generally slow to absorb the implications of these activities into valuations.
- There are two activities, diversity and the environment, where it would appear beneficial for a firm to satisfy both regulatory requirements and meet community norms in order to avoid being punished by the market.
- Being proactive in the employments area (i.e., being regarded as a ''good'' employer) would be one area that is rewarded by the market.
- In contrast, being proactive with respect to environmental issues would appear to have a negative impact on market valuation.

We return to further consider these findings later in the paper but before doing so we will extend our analysis to (i) examine whether there has been any noticeable change in the relationship between CSR activities and market valuation over the period of our sample and (ii) consider whether the overall reputation created by these activities has an impact on market valuation.[14]

Analysis of independent CSR activities over two sub-periods

In order to identify trends in the relationships that we are evaluating, we divided our data period up into 1991–1996 and 1997–2003 and then repeated our analysis. We report details in Table VI only of the CSR variables that prove to be significant in the case of each of the three dependent variables.

The only relationship, which consistently holds over the entire sample period is the negative relationship between environmental concerns and future market returns. There are two CSR activities that had a definite impact on market returns during the first half of our sample period but which were not apparent during the second half. One of these relationships was community strength with the evidence suggesting that the market more than amply rewarded those companies who practiced philanthropic activities in earlier times but more recently has turned neutral to such activities. The other relationship was the previously discussed surprising positive relationship between product concerns and market performance, which also seems to have been reflective of market behaviour in the earlier period.

There would appear to be four strong findings, in addition to environmental concerns, that held through the more recent sub-period. The somewhat perplexing but previously discussed positive relationship between community concerns and future excess returns held only during this period. This represents a quite significant turnaround as in the first sub-period the market had been rewarding companies for their contributions to the community. Diversity seems to only be an activity on which the market has concentrated in recent times either rewarding companies for being proactive in this area or punishing companies who had failed to satisfy minimum standards. The same can be said for employee-related activities, which also have only come under the notice of the market in recent times. In particular, the market would seem to now be rewarding companies for following "good" employee practices. Finally, there are the environmental activities where the market has always been concerned about companies that fall short in this area. However, in more recent times, the market has not looked favourably on companies that are proactive in the area of environmental protection.

The one overriding finding from the analysis is that the markets reaction to different CSR activities would appear to change over time and that this provides a challenge to managers trying to juggle the interests of the company's shareholders with those of a wider stakeholder group. The indication from our analysis of the more recent period would suggest that diversity, employee-related activities and the environment are key areas of concern to the market with the market being neutral to activities in other areas

TABLE VI

Coefficients of significant CSR variables: 1991–1996 and 1997–2003

Variable	1991–1996			1997–2003		
	One-year returns	Two-year returns	Three-year returns	One-year returns	Two-year returns	Three-year returns
COMMUNITY CONCERNS					0.1267*	0.1498*
COMMUNITY STRENGTHS	0.0193*	0.0425*	0.0551*			
DIVERSITY CONCERNS					−0.0766*	−0.1150*
DIVERSITY STRENGTHS				0.0236*		
EMPLOYEE CONCERNS			−0.0786*			
EMPLOYEE STRENGTHS				0.0212**	0.0460*	
ENVIRONMENT CONCERNS		−0.0322*	−0.0718*	−0.0237*	−0.0394*	−0.0431*
ENVIRONMENT STRENGTHS				−0.0298**	−0.0441**	
PRODUCT CONCERNS	0.0233*	0.0834*	0.1480*			
PRODUCT STRENGTHS						
Adjusted R^2	7.15%	5.23%	4.51%	2.72%	2.33%	2.41%

with the exception of having a negative disposition towards those companies that undertake what they regard as excessive expenditure in the area of environmental protection.

Analysis of combined scores across all CSR activities over the entire sample period

The analysis to date has concentrated on the relationship between the ratings of companies on single CSR activities and their future stock returns. Many of the previous studies relating to CSR activities and performance have used an aggregated score across several CSR activities with the majority finding a positive correlation between this aggregated score and future performance. This may suggest that even if individual activities are not that highly valued by the market, a company embracing a large numbers of these activities may well earn the support of the market. Such an outcome would be consistent with a large proportion of any benefits that a company may enjoy from its CSR activities being a consequence of the overall reputation of the company attributable to the breadth of such activities rather than the individual activities themselves. In order to obtain a better insight into this issue, we evaluate whether the aggregate of each company's strength scores across all CSR activities, and also its concern scores, were correlated with future market returns.

Our findings as reported in Table VII suggest that a company might more immediately benefit using its CSR activities to create a reputation of it being a good corporate citizen. However in the longer-term, it would appear that the market places more weight on a company avoiding obtaining a tainted image as a result of failing to meet regulatory requirements and community standards. This finding is paralleled by our previous experience with diversity where being proactive with respect to women and minorities benefited market performance in the short-term but it was avoiding controversies and meeting minimum standards, which brought longer-term benefits.

TABLE VII

Coefficients attached to combined CSR variables (1991–2003)

Variable	1-year Returns	2-year Returns	3-year Returns
ALL_CONCERNS	−0.0043	−0.0084**	−0.0171*
ALL_STRENGTHS	0.0063*	0.0080*	0.0083
Adjusted R^2	1.99%	1.29%	1.13%

*Significant at 5% level.

**Significant at 10% level.

The overall results are encouraging for a manager wishing to merge stakeholder theory with the narrower neo-classical objective of the firm as they suggest that firms who are most active in pursuing CSR activities will be rewarded in the market place. However, we have previously seen that such management might be best advised to be discriminating in the activities that they most actively pursue paying particular attention to avoiding concerns in the areas of diversity and the environment, being proactive in the area of employee relations but avoiding over-expenditure on community and environmental activities.

Changes in CSR activities

The results reported to date have been based on the absolute CSR scores as provided by KLD. We propose that we obtain greater insights from analysing these absolute scores, rather than changes in the scores because we believe that the impact that CSR activities have on company valuation will more reflect the market's perception of the extent of these activities rather than be influenced by marginal changes in the extent of these activities.

In order to test this proposition further, we analysed the relationship between changes in the CSR scores and future market returns and our findings are reported in Table VIII. The most striking facet of the reported findings is that very few of the changes identified impact on future market excess returns. There are 20 change variables but only two of them (10%) would appear to provide any consistent explanatory power, supporting the proposition that markets do not attach much significance to the announcement of a change in a company's score for each of the various CSR activities. The one variable that seems to explain a consistent explanation is the increase in Community concerns where such increases are taken as providing positive news to the market. This might appear a

TABLE VIII

Coefficients attached to changes in CSR variables (1991–2003)

Variable	1-year Returns		2-year Returns		3-year Returns	
	Coefficient	*p*-Value	Coefficient	*p*-Value	Coefficient	*p*-Value
COMMUNITY_CONCERNS PLUS	0.1438	0.0023	0.1817	0.0153	0.2603	0.0179
COMMUNITY_STRENGTHS PLUS					−0.1471	0.0276
EMPLOYEE_CONCERNS MINUS			−0.0980	0.0354	−0.1710	0.0144
Adjusted R^2	1.53%		1.37%		2.27%	

surprising result, but it does confirm our previous finding that company's with higher community concern scores do perform better in the market place.

CSR activities and valuation multiples

The analysis to date has concentrated on the relationship between CSR activities and future excess market returns over various holding periods on the basis that these returns provide the best basis for providing insights into the impact of these activities on what is of most concern to us, owner wealth. Valuation metrics such as market-to-book or price-to-earnings provide an alternative basis for measuring this impact in that they encapsulate in one number the market expectations with respect to both future returns and the perceived risks attached to these returns.

Table IX reports the significant relationships that we found between these valuation metrics and each of the CSR activities. Perhaps, the first observation to make is that we get a broader spectrum of significant results with these valuation multiples as the dependent variables than we obtained using the excess returns. *A priori* one would assume that strengths would have a positive effect on a valuation multiple and concerns would have a negative impact. This was the case in all instances other than community strengths where increased activities in this area was associated with a fall in a company's valuation multiple. As strengths in this area reflect philanthropic activities, it may well be that the market does not reward companies that they consider to be overly generous.

The findings obtained using valuation multiples as dependent variables confirm strong previous findings that avoiding environmental concerns and pursuing employment strengths are both considered important activities by the market which can have a positive impact on market valuation. However, they also identified community, diversity and product strengths and employment concerns as CSR activities that impact on valuation which are variables that previously had been found to have little or no relationship with future excess returns. The reason for these different findings probably lies in the fact that the valuations multiples represent the sentiment of the market at a specific date while the returns measure the market reaction over a much longer period of time (up to three years). As a consequence the valuation multiples are picking up different phenomena although it is encouraging that the results from using the valuation multiples do not contradict our previous findings except in the case of the apparent reaction to community concerns.

We also evaluated the relationship between the aggregate of the concern and sentiment scores with the valuations multiples and found that they were both significant and also had the expected sign. This largely confirms previous findings, which suggest that companies habitually breaching community norms and regulations with respect to CSR issues are likely to be punished by market participants whereas those that create an image of being generally proactive in these activities are likely to benefit in the market place.

Summary and conclusions

In introducing Enlightened Stakeholder Theory, Jensen (2001) provided a compromise to resolve the

TABLE IX

Valuation multiples: coefficients of significant CSR variables (1991–2003)

Variable	Market-to-book		Price-to-earnings	
	Coefficient	*p*-Value	Coefficient	*p*-Value
COMMUNITY_CONCERNS	−0.5133	0.0003		
COMMUNITY_STRENGTHS	−0.2664	0.0000	-1.2950	0.0000
DIVERSITY_CONCERNS				
DIVERSITY_STRENGTHS	0.4274	0.0000	1.1289	0.0000
EMPLOYEE_CONCERNS	−0.3422	0.0000		
EMPLOYEE_STRENGTHS	0.2766	0.0000	1.2487	0.0000
ENVIRONMENT_CONCERNS	−0.2670	0.0000	-0.5921	0.0039
ENVIRONMENT_STRENGTHS				
PRODUCT_CONCERNS				
PRODUCT_STRENGTHS	0.2412	0.0001	1.3328	0.0068
Adjusted R^2	8.30%		9.47%	

conflict for corporate management drawn between managing a firm solely in the interests of its shareholders (the neo-classical view) and managing the firm in the interests of stakeholders very broadly defined (the stakeholder theory view). The source of the compromise being that it is extremely unlikely that management can maximise the value of the company to its owners by following a strategy of ignoring the interest of the other stakeholders. Under this ‘‘enlightened'' approach, management will automatically take account of the interests of other parties in making their decisions where by so doing it does not conflict with the interests of the company's stockholders.

The focus of this paper has been on evaluating a range of CSR activities to determine their impact on the value of the firm to its owners. It is only where this impact is demonstrably negative that a conflict exists with a neutral or positive impact being indicative that pursuing these activities is not coming at the direct cost of owners. Our major findings are:

- The most consistent results that we obtained are related to employment strengths and environmental concerns. The evidence suggests that the valuation of those companies will be positively impacted if they are not proactive in the area of industrial relations and negatively impacted if they are identified as failing to meet regulatory and community standards with respect to the environment.
- Another area in which good CSR practice is rewarded is in the diversity area where the evidence suggests a negative relationship exists between diversity concerns and excess returns and a positive relationship between strengths and excess returns.
- The area of community issues would seem to be where there is the greatest potential conflict between CSR activities and market valuation. It seems that the market no longer values philanthropic activities nor does it seem too concerned in instances where a company publicly conflicts with the community. One observation we would make is that the KLD ratings were not necessarily developed to correlate with market valuation and this might be particularly true with respect to the community area.
- There are a few areas where the evidence suggests a possible conflict for management trying to balance the interests of stockholders with those a broad spectrum of stakeholders. The most surprising being the environmental area where the market would appear to punish those companies with a high environment strength score. Although the market would appear to want companies to meet minimum environmental standards, it is not supportive of companies who voluntarily go well beyond this.
- We do document that the markets attitude towards CSR activities would appear to

change overtime. In particular, we have seen that diversity, employment and environmental issues have been of greatest interest in more recent years.

- Finally, we found evidence to suggest that companies that are identified as either devoting significant resources (pursuing poor practices) across a wide spectrum of CSR activities will be rewarded (penalised) in the market place. In other words, there seems to be reputational benefits (costs) flowing from CSR activities that go beyond those associated with the independent CSR activities.

The weight of evidence from our study suggests that management can consider the interests of a diverse set of stakeholders without significantly compromising the wealth of company stockholders. In particular, we observed that stockholders of companies that particularly target the interests of a broad spectrum of stakeholders will probably benefit while those in companies that are continually fail to meet regulatory and social norms are likely to suffer.

The implications that we can draw from our analysis is that the neo-classical view that management should seek to maximise the owner wealth will (i) encourage them to meet legal requirements and minimum community standards across a broad range of CSR activities and (ii) in certain activities, particularly employee-related, to go well beyond these minimum legal and community requirements. However, the study does highlight some areas of possible concern and, in particular, that management pursuing the objective of maximising owner wealth will not have the incentive to be proactive in their environmental policy. This suggests that areas still exist where the Government will have to play an active role in ensuring that companies meet the legitimate concerns of certain stakeholders.

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Notes

[1] It is not the purpose of this paper to argue the case for and against Stakeholder Theory being the driving force for decision-making within the company but rather our concern is with the conflicts that Stakeholder Theory brings management in deciding how to best utilise the scarce capital resources of the company.

[2] Several writers have attempted to propose a solution to this problem (e.g., Pava and Krausz, 1997) but they all involve ill-defined trade offs.

[3] In a similar vein De George (1978) makes the point that there will be many instances where moral behaviour is consistent with realising one's business objectives but where this is not the case then public pressure or legal measures can be brought to bear to make immoral behaviour unprofitable.

[4] The reason that these numbers add up to more than 51 is because some papers found more than one relationship (e.g., some that were positive and some that were negative).

[5] See, for example, Ullman (1985), Waddock and Graves (1997) and Ruf et al. (2001).

[6] See Wood and Jones (1995).

[7] See Boutin-Dufresne and Savaria (2004).

[8] There were insufficient ratings to evaluate the other two activities: Corporate Governance and Human Rights.

[9] This second option allowed us to empirically investigate more complex relationships between CSR scores and financial performance other than simply linear ones. In particular, as Bowman and Haire (1975) and, more recently, Moore (2001) pointed out, there may be an optimal level of social performance beyond which the expenditures devoted to such activities detract from rather than contribute to financial performance. In those cases, the sign of the coefficients associated to the score "1" should differ from the sign of the coefficient associated, for the same activity, to a score of "2".

[10] We also including each companies industry classification as a dummy, but these proved insignificant so we excluded them from our final analysis.

[11] The evidence that the two options yield identical finding do not support the idea (Bowman and Haire, 1975; Moore, 2001) that it may be an optimal level of social performance beyond which the expenditures devoted to such activities detract from rather than contribute to financial performance.

[12] There is much evidence in the finance literature of security prices overreacting to corporate events. See, for example, De Bondt and Thaler (1985).

[13] These findings also suggest that that an event study analysis might be more appropriate to evaluate those activities where the KLD ratings are largely reflective of major corporate events.

[14] Brammer and Pavelin (2006) demonstrate that the reputational effect of social performance will not always translate into higher corporate valuation.

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