The Relationship between Corporate Social Performance and Corporate Financial Performance: Industry Type as a Boundary Condition

Masud Chand, Ph.D. Candidate, Simon Fraser University, BC, Canada

ABSTRACT

This paper examines the relationship between Corporate Social Performance (CSP) and Corporate Financial Performance (CFP). It starts with a brief look at the numerous previous studies that have been conducted on this topic, and the reasons for their lack of consensus and comparability. It then makes the case for the use of industry type as a boundary condition for exploring this relationship. This would overcome the problems that previous cross sectional studies had faced. The paper then goes on to demonstrate that once industry type is established as a boundary condition, the relationship between CSP and CFP is clear and positive.

INTRODUCTION

The link between the Corporate Social Performance (CSP) and Corporate Financial Performance (CFP) has been exhaustively investigated over the last 30 years. In fact, between 1970 and 1995, 51 studies have examined this link. Almost all these studies have been cross sectional studies that looked at organizations across different industries. This paper suggests using industry type as a boundary condition for investigating the link between CSP and CFP. Controlling for industry will eliminate all the environmental differences that organizations in different industries face that tend to cloud this relationship. This paper will go on to demonstrate that controlling for industry, a clear positive link can be shown between CSP and CFP. This link is stronger when between poor CSP and poor CFP; it is somewhat weak in the correlation between good CSP and good CFP.

Corporate Social Responsibility

The World Business Council for Sustainable Development in its publication "Making Good Business Sense" (Holme and Watts, 1999), used the following definition: "Corporate Social Responsibility is the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large."

Michael Hopkins in his book 'A Planetary Bargain: Corporate Social Responsibility Comes of Age' (Macmillan, UK, 1998) defined 'Corporate Social Responsibility is concerned with treating the stakeholders of the firm ethically or in a socially responsible manner. Stakeholders exist both within a firm and outside. Consequently, behaving socially responsibly will increase the human development of stakeholders both within and outside the corporation'.

DIFFERENT APPROACHES TO CSR

The CSR field presents a number of different theories and approaches that are complex and in some cases contradictory. We now look at the main CSR approaches and classify them into four major groups: 1) instrumental theories, in which the corporation is seen as only an instrument for wealth creation, and its activities are only a means to achieve economic results; (2) political theories, which concern themselves with the power of corporations in society and a responsible use of this power in the political arena; (3) integrative theories, in which the corporation is focused on the satisfaction of social demands and (4) ethical theories, based on ethical responsibilities of corporations to society. (Garriga and Mele, 2004).

Instrumental Theories

In this group of theories CSR is seen only as a strategic tool to achieve economic objectives and, ultimately, wealth creation. Representative of this approach is the well-known Friedman view that "the only one responsibility of business towards society is the maximization of profits to the shareholders within the legal framework and the ethical custom of the country" (Friedman 1970).

Concern for profits does not exclude taking into account the interests of all who have a stake in the firm (stakeholders). It has been argued that in certain conditions the satisfaction of these interests can contribute to maximizing the shareholder value. An adequate level of investment in philanthropy and social activities is also acceptable for the sake of profits (McWilliams and Siegel, 2001).

Political Theories

These theories focus on the interactions between business and society and on the power and position of business and its inherent responsibility. They include both political considerations and political analysis in the CSR debate. Two major theories can be distinguished here: Corporate Constitutionalism and Corporate Citizenship.

Corporate Constitutionalism: Davis (1960) was one of the first to explore the role of power that business has in society and the social impact of this power. In doing so, he introduces business power as a new element in the debate of CSR. He held that business is a social institution and it must use power responsibly. Additionally, Davis noted that the causes that generate the social power of the firm are not solely internal of the firm but also external.

Integrative Social Contract Theory: Donaldson (1982) considered the business and society relationship from the social contract tradition, mainly from the philosophical thought of Locke. He assumed that a sort of implicit social contract between business and society exists. This social contract implies some indirect obligations of business towards society. This approach would overcome some limitations of deontological and teleological theories applied to business. Afterwards, Donaldson and Dunfee (1994, 1999) extended this approach and proposed an Integrative Social Contract Theory in order to take into account the socio-cultural context and also to integrate empirical and normative aspects of management.

Integrative Theories

This group of theories looks at how business integrates social demands, arguing that business depends on society for its existence, continuity and growth. Social demands are generally considered to be the way in which society interacts with business and gives it a certain legitimacy and prestige. As a consequence, corporate management should take into account social demands, and integrate them in such a way that the business operates in accordance with social values. So, the content of business responsibility is limited to the space and time of each situation depending on the values of society at that moment, and comes through the company's functional roles (Preston and Post, 1975). In other words, there is no specific action that management is responsible for performing throughout time and in each industry. Basically, the theories of this group are focused on the detection and scanning of, and response to, the social demands that achieve social legitimacy, greater social acceptance and prestige.

Ethical Theories

This group of theories or approaches focuses on the ethical requirements that cement the relationship between business and society. They are based on principles that express the right thing to do or the necessity to achieve a good society. The most well known of these approaches is the Normative Stakeholder Theory. Its main exponent is R. Freeman, who in his book "*Strategic Management: A Stakeholder Approach*" argued that managers bear a fiduciary responsibility to all stakeholders, not just shareholders. (Freeman, 1984).

CORPORATE FINANCIAL PERFORMANCE

Researchers in this area have used numerous measures of corporate financial performance. These measures can be broadly classified in to the following categories:

1) Profitability- including Return on Equity and Return on Sales
2) Asset Utilization- mostly return on assets, in some cases risk adjusted
3) Growth- including % change in assets, % change in sales, % change in employees-year to year, 3 or 5 year averages
4) Liquidity – Cash flow, acid test and pay out ratios
5) Risk Market measures- in terms of excess market valuation/abnormal returns-means and medians. Includes use of Alpha and Beta and change in share prices.

Of these measures, Profitability, Asset Utilization and Risk measures have by far been the most common.

CORPORATE SOCIAL PERFORMANCE

Corporate Social Performance (CSP) is inherently much more difficult to measure than CFP. This is not only because of the subjective nature of the topic, but also because of the diverse nature of issues that fall under it.

CSP is a multi dimensional construct with behaviors ranging across a wide range of inputs (e.g. Investments in pollution control equipment or other environmental strategies), internal behaviors or processes (e.g. treatment of women and minorities, nature of products produced, relationships with customers), and outputs (community relations and philanthropic programs) These behaviors occur across a wide range of industries with significantly different characteristics, histories and performances in the different CSP domains (Waddock and Graves 1997). Further, numerous issues, managerial decisions and corporate behaviors are encompassed by the term CSP. As a result, little clarity has been reached on measurement of CSP. CSP measures commonly used include forced choice survey instruments, the Fortune Reputation index, numerical one dimensional screens such as the Toxics Release Inventory (TRI), hybrids of perceptual and numerical measures such as the KLD index and Corporate Philanthropy measures.

Forced choice instruments are researcher-designed surveys that measure dimensions that the researcher considers to be important. These are subjective measures and very difficult to compare from study to study.

In Fortune's survey, "senior executives, outside directors and financial analysts rate the ten largest companies in their own industry on eight attributes of reputation, using a scale of zero(poor) to ten (excellent)" (Fortune, 1994, 58) . Results are summed to create and overall reputation index.

The KLD index was created by the financial analysis firm Kinder, Lydenberg and Domini & co. Inc. It assesses each company on eight dimensions of corporate social performance "by referring to a consistent, largely objective set of screening criteria" (Graves and Waddock 1994). The eight dimensions are community relations, employee relations, environment, product, treatment of women and minorities, military contracts, nuclear power and South African involvement. The first five dimensions are assessed on a four-point scale from major strength to major weakness. The last three dimensions, if present, are measured on a dichotomous scale: minor weakness or major weakness. By rating firms on multiple measures of social performance, using largely objective screening criteria, this index provides greater objectivity than the largely perception based Fortune survey.

The Toxics Release Inventory (TRI) is used primarily by the government and special interest groups for the purpose of tabulating the relative amounts of discharges into the environment (US Environmental Protection Agency 1995). It consists of self-reported information on discharges to the water, air and landfills and to disposal of hazardous wastes.

The other major measure of CSP is corporate philanthropy. This data can be obtained from the *Corporate 500 Directory of Corporate Philanthropy*. It looks at the large firm's philanthropic activities and compares all firms against one another. In addition, this report looks at the difficulty of obtaining money from the firm. It provides a listing of all types of activities the firm supports along with a map showing the geographic area the firm concentrates on in its giving activities.

THE LINK BETWEEN CORPORATE SOCIAL PERFORMANCE AND CORPORATE FINANCIAL PERFORMANCE

Although numerous researchers have explored the link between CSP and CFP, no definitive consensus exists as to its impact. The results have often been contradictory, even within a given analysis. Some researchers have found a negative relationship (Bromiley and Marcus 1989, Davidson, Chandy and Cross 1987, Davidson and Worell 1988, Wier 1983); others have found an inconclusive relationship (Alexander and Buchholz 1976, Abott and Monsen 1979, Auperrle, Carroll and Hatfield 1985, Ingram and Frazier 1983). The largest number of researchers, however, have found a positive relationship (Bowman 1978, Cowen, Ferreri and Parker 1987, Fry, Keim and Meiners 1982, Ingram 1978, Moskowitz 1972,1975, Spencer and Taylor 1987, Sturdivant and Ginter , 1977 and Waddock and Graves 1994)

Even though a large number of studies have shown a positive relationship, academics and practioners alike should be concerned about the variability and inconsistency of the results. (Griffin, Mahon 1997). Some of the reasons for these contradictory results stem from conceptual, operationalization and methodological differences in the definitions of social and financial performance (Cochran and Wood, 1984, Watrick and Cochran 1985, Wood 1991).

If we look at studies on this topic done between 1970 and 1995, we have a wide range of outcomes. Of the 51 studies done, 33 show a positive link, 9 no link or inconclusive and 9 a negative link. This leads us to take a closer look at the environmental factors under which the studies were conducted- like performance measures used, specific industries and economic conditions.

During this said period, researchers have used 80 different financial measures of corporate performance. Of these, 57 measures have been used by only one researcher at one time. Without repeated use of the same measures, it is difficult to develop validity or reliability checks for most of these financial measures (Griffin and Mahon 1997).

The differences in the use of CSP measures are even more marked. Researchers have used self designed questionnaires, perceptual measures such as the Fortune survey, uni dimensional performance measures, such as the TRI reports or the Corporate Philanthropy reports, hybrid measures, such as the KLD index, or any combinations of these methods. This makes comparison across studies extremely difficult.

Individual industries operate within distinct contexts and with different social and environmental concerns. As a result, previous studies that have been across industries may have masked specific industry effects and actual social performance in that social performance and financial performance are shown to be related within an industry over time(Griffin and Mahon 1997). By analyzing broad, cross sectional data, these studies may mask individual differences for measuring CSP and CFP in the context of that of an industry. Industries exhibit special uniqueness in that the internal competencies or external pressures inherent in a given industry create a 'specialization' of social interests (Holmes 1977). Hence the internal and external pressures in a given industry, such as government regulations, public visibility etc are expected to be the same within an industry. Different industries face different configurations of stakeholders, with different degrees of activisms on differing issues. Multi industry studies tend to confound this relationship (Griffin and Mahon 1997).

Broad based studies thus tend to downplay the wide differences in stakeholder activism that exist across different industries. The degree of activism and public interest in the activities of say, an airlines and a nuclear power plant are very different. It is almost pointless to compare their social performances with each other. Ideally, CSP measures should be collected from multiple sources over a period of time and the relationship with CFP investigated over that period. This brings us to the first proposition of this paper:

Proposition 1: Research on the link between CSP and CFP will have greater validity and accuracy if it is focused on a single industry. The use of industry as a boundary condition, together with consistency of financial measures used and multiple measures of corporate social performance, will lead to results that are more reliable and comparable.

Only 3 articles in this 25-year period (Bromiley and Marcus, 1989, Davidson, Chandy and Cross 1987 and Rockness, Schlachter and Rockness 1986) look at one specific industry. Each of these focused on the reaction of the stock market to illegal corporate actions. Bromiley and Marcus used industry as a boundary condition and examined the reaction of stock prices to auto industry product recalls between 1967 and 1983. Their findings indicated that auto recalls negatively affected stock prices (though they argued that this by itself was not a sufficient deterrent from producing unsafe cars). There was a clear link between low CSP (that led to auto recalls) and low CFP (illustrated by falling stock prices).

Davidson, Chandy and Cross in 1986 examined the airline industry between the years 1965 to 1984. They looked at the relationship between major airline crashes and stock prices. Airline crashes were deemed as similar to corporate responsibility (or lack of) and were linked to changes in stock prices around this time. They found that crashes significantly reduced the stock price in the short term. In the long term, however, there was little evidence of change in stock valuation. They speculated that firstly, airline companies were large in relation to their crash losses and secondly, investors had factored the probability of these losses in the long term. The link between airline crashes and short-term stock market losses however was clear. Once more, if industry was used as a boundary condition, there was a clear link between low CSP and low CFP.

Rockness, Sclachter and Rockness in 1986 investigated the link between hazardous waste disposal, corporate disclosure and corporate financial performance. They found no clear relationship between measures of social performance and financial performance. In this case, the link between CSP and CFP was inconclusive.

Griffin and Mahon in 1995 looked at the link between CSP and CFP in the chemical industry. 6 major companies in the industry were surveyed-Dow Chemical, DuPont, PPG, W.R. Grace, Occidental Petroleum and Union Carbide. Their performances were rated on 3 dimensions of social performance and 5 dimensions of financial performance. Their findings show that companies high on the CSP scale also tend to be high on the CFP scale. Only one of the surveyed companies, PPG, exhibited a low CSP together with a high CFP. Thus with industry set as a boundary condition, high CSP was always linked to a high CFP, and a low CSP with a low CFP in most cases.

Looking at the overall results, when industry was set as a boundary condition, in two of the first three cases, faulty products/services led to decline in shareholder wealth (in one, there was no conclusive link). If we consider faulty products/ irresponsible corporate behavior as bad CSP, and declining shareholder value as bad CFP, we can speculate about a link between the two. In the more recent Griffin and Mahon study, there is a clear relationship between high CSP and high CFP, as well as a less clear but nonetheless visible relationship between low CSP and low CFP. This brings us to the second proposition of this paper:

Proposition 2: If industry is set as a boundary condition, a low level of CSP by a firm will lead a low level of CFP.

Three of the four studies used have been about dealing with low levels of CSP – faulty products, plane crashes and irresponsible waste dumping. Of these 2 point to low CSP leading to low stock market prices and ultimately low CFP (Bromiley and Marcus, 1989, Davidson, Chandy and Cross 1987), while one shows no noticeable link (Rockness, Sclachter and Rockness in 1986). In the Griffin and Mahon 1995 article, companies with low levels of CSP tended to be at low levels of CFP as well. Taken as a whole, the moderating effect of industry on the relationship between CSP and CFP is clear. There is a clear positive link between CSP and CFP when industry is set as a boundary condition. This link is stronger and more visible at lower levels of CSP. Proposition 2 is an easier proposition to defend than the more assertive" A high level of CSP leads to a high level of CFP", since the first three studies were actually dealing only with low CSP situations.

However, it should be noted that this link between poor CSP and CFP is not causal. Based on these studies, poor CSP is not a cause for poor CFP. The proposition merely argues that if a firm is performing poorly in the CSP aspect, it is more likely to be performing poorly on the CFP aspect as well. At this point, the opposite proposition that high CFP actually leads to high CSP can also not be ruled out. In Griffin and Mahon 1997, high CFP was always associated with high CSP, but the reverse was not necessarily true.

CONCLUSIONS AND IMPLICATIONS

The link between Corporate Social Performance and Corporate Financial Performance has been repeatedly investigated over the last thirty years. However, as yet, there are no conclusive findings as to direction or strength of this relationship. In fact, many studies have concluded that there actually isn't any significant relationship between the two. This article draws attention to three main facts. Firstly, the great variation in findings among the different studies on this relationship is a result of the differences in measurement methods used, both for social and financial performance. Also, the inherent differences in stakeholder interests and activities across different industries make comparison among industries almost impossible. Thus research on the link between corporate social performance and corporate financial performance will have greater validity and accuracy if the focus is on a single industry.

Secondly, since CSP is such a subjective topic, researchers should take into account its multiple dimensions, as well use data from different sources. This will make the calculation of corporate social performance more objective, as well as ensure greater consistency and comparability across studies. Finally, when controlling for industry, (Bromiley and Marcus, 1989, Davidson, Chandy and Cross 1987, Rockness, Schlachter and Rockness, 1986 and Griffin and Mahon, 1997) firms scoring low on CSP also tend to score low on CFP.

The importance of these findings is threefold. Firstly, using industry as a boundary condition will overcome the automatic shortcoming that cross sectional studies have of overlooking the differences in stakeholder activism and interests across industries. Is will serve to increase the internal validity of these studies. Secondly, the inconsistencies across various CSP measures will be greatly reduced by using multiple measures and data sources. And finally, this paper establishes a positive link between CSP and CFP in any given industry which can now be studied in a more objective and systematic fashion using the methods previously outlined.

Further research is needed to study both the strength and direction of the proposed relationship between CSP and CFP. This would ideally mean a greater number of recent single industry studies exploring this relationship. Another avenue of further research is the design of a comprehensive framework to measure corporate social performance. This proposed framework could include both perceptual and performance measures found in the Fortune, KLD, TRI and Corporate 500 Philanthropy surveys. Researchers could assign different weights to different dimensions depending on the industry they are studying.

The proposals here have implications both for researchers and corporate managers. For researchers, there is the possibility of designing more consistent, accurate and comparable studies to examine this relationship. For corporate managers, the proposed positive relationship between CSP and CFP could have business implications that could change the way in which they look at the concept of corporate social responsibility.

REFERENCES

Abott, W. & Monsen, R. (1979). On the Measurement of Corporate Social Responsibility: Self Reported Disclosures and a Method of Measuring Corporate Social Involvement. *Academy of Management Journal 22(3): 501-15*

Alexander, G. & Buchholz, R. (1978). Corporate Social Responsibility and Stock Market Performance. *Academy of Management Journal 21 (3): 479-86*

Aupperle, K., Caroll, A., & Hatfield, J. (1985). An Empirical Examination of the Relationship between Corporate Social Responsibility and Profitability. *Academy of Management Journal 28(2): 446-63*

Bowman, E. (1978). Strategy, Annual Reports and Alchemy. *California Management Review 18 (2): 49-58*

Bromiley, P & Marcus, A. (1989). The Deterrent to Dubious Corporate Behavior: Profitability, Probability, and Safety Recalls. *Strategic Management Journal 10; 233-250*

Caroll, A.B (1991). The Pyramid of Corporate Social Responsibility: Towards the Moral Management of Organizational Stakeholders. *Business Horizons (July/August), 39-48*

Cochran, P & Wood, R. (1984). Corporate Social Responsibility and Financial Performance. *Academy of Management Journal 27 (1): 42-56*

Corporate 500: Directory of Corporate Philanthropy (10th edition). 1991-92, San Francisco CA.

Davidson, W.N., Chandy P.R.,& Cross, M. (1987). Large losses, Risk Management and Stock Returns in the Airline Industry. *Journal of Risk and Insurance 55: 162-72*

Davis, K (1967). Understanding the Social responsibility Puzzle. *Business Horizons 10 (4), 45-51*

Davis, K. (1960). Can Business Afford to Ignore Corporate Social Responsibilities? *California Management Review 2, 70-76*

Donaldson, T & Dunfee, T. (1994). Towards a Unified Conception of Business Ethics. *Academy of Management Review 19, 252-84*

Donaldson, T & Dunfee, T. (1999).*Ties that Bind: A Social Contracts Approach to Business Ethics.* Harvard Business School Press, Boston.

Donaldson, T.(1982). *Corporations and Morality.* Prentice Hall, Englewood Cliff, NJ.

Fortune, (1994), February. America's Most Admired Corporations. P58

Freeman, R.E. (1984). *Strategic Management: A Stakeholder Approach.* Pitman, Massachusetts

Friedman, M.(1970). 'The Social Responsibility of Business is to Increase its Profits', *New York Times Magazine, September 13, 32-33*

Frooman, J.(1997). Socially Irresponsible and Illegal Behavior and Shareholder. *Business and Society 36 (3), 221-250*

Fry, F., Keim, G. & Meiners, R. (1982). Corporate Contributions: Altruistic or for Profit? *Academy of Management Journal 25 (1): 94-106*

Garriga, E. & Mele, D (2004). Corporate Social Responsibility Theories: Mapping the Territory. *Journal of Business Ethics 53 (1-2), 51-71*

Graves, S. and Waddock, S. (1994). Institutional Owners and Corporate Social Performance. *Academy of Management Journal 37 (4): 1034-46*

Griffin, J. & Mahon, J. (1997). The Corporate Social Performance and Corporate Financial Performance Debate: Twenty Five Years of Incomparable Research. *Business and Society 36 (1), 5-31*

Holme, Lord, & Watts, Richard (1999). *Making Good Business Sense.* The World Council for Sustainable Development.

Holmes, S. (1977). Corporate Social Performance: Past and Present Areas of Commitment. *Academy of Management Journal 20 (3): 433-38*

Hopkins, Michael (1998). *A Planetary Bargain: Corporate Social Responsibility Comes of Age.* Houndmills, MacMillan Press Ltd.

Ingram, R & Frazier, K. (1980). Environmental Performance and Corporate Disclosure. *Journal Of Accounting Research 18(2): 614-21*

Ingram, R (1978). An Investigation of the Information Content of Social Responsibility Disclosures. *Journal of Accounting Research 16(2): 270-85*

Key, S & Popkin, S (1998) Integrating Ethics into the Strategic Management Process: Doing Well by Doing Good. *Management Decision 36 (5-6), 331-339*

Mahon, J.F. &McGowan, R.A (1991). Searching for the Common Good: A Process oriented Approach. *Business Horizons 34(4), 79-87*

McWilliams, A. & D Siegel (2001). Corporate Social Responsibility: A Theory of the Firm Perspective. *Academy of Management Review 26(1), 117-127*

Moskowitz, M (1972). Choosing Socially Responsible Stocks. *Business and Society Review 10 : 71-5*

Moskowitz, M (1975). Profiles in Corporate Responsibility: The Ten Worst and the Ten Best. *Business and Society Review 13: 28-42*

Preston, L.E. (1975). Corporation and Society: The Search for a Paradigm. *Journal of Economic Literature 13(2), 434-454*

Rockness, J, Schlachter, P.& Rockness, H. (1986). Hazardous Waste Disposal, Corporate Disclosure and Financial Performance in the Chemical Industry. *Advances in Public Interest Accounting I :167-91*

Spencer, B. & Taylor, G. (1987). A Within and Between Analysis of the Relationship between Corporate Social Responsibility and Financial Performance. *Akron Business and Economic Review 18 (3): 7-18*

Sturdivant, F. & Ginter, J (1977). Corporate Social Responsiveness: Management Attitudes and Economic Performance. *California Management Review 19(3): 30-9*

US Environmental Protection Agency (1995). *Toxics Release Inventory: Public Data Release.* Washington DC

Waddock, S.A & Graves, S.B.(1997). The Corporate Social Performance-Financial Performance Link. *Strategic Management Journal 18(4), 303-320*

Wartick, S., & Cochran, P. (1985). The Evolution of the Corporate Social Performance Model. *Academy of Management Review 10(4): 758-69*

Watrick, S. & Rude, R (1986). Issues Management: Corporate Fad or Corporate Function?. *California Management Review 29(1), 124-132*

Wier, P(1983). The Costs of Anti-Merger Lawsuits: Evidence from the Stock Market. *Journal of Financial Economics 11: 207-224*

Wood, D.J & Lodgson, J.M. (2002). Business Citizenship: From Individuals to Organizations. *Business Ethics Quarterly, No. 3, 59-94*