

CORPORATE SOCIAL RESPONSIBILITY AND ITS IMPACT ON THE
CORPORATE DECISION-MAKING PROCESS
FOR UNIVERSITY UNDERGRADUATE
RESEARCH FELLOWS

A Senior Honors Thesis

by

JOSEPH E. BAIN

Submitted to the Office of Honors Programs
& Academic Scholarships
Texas A&M University
in partial fulfillment for the designation of

UNIVERSITY UNDERGRADUATE
RESEARCH FELLOW

April 2003

Group: Education, Business & Life Science

CORPORATE SOCIAL RESPONSIBILITY AND ITS IMPACT ON THE
CORPORATE DECISION-MAKING PROCESS
FOR UNIVERSITY UNDERGRADUATE
RESEARCH FELLOWS

A Senior Honors Thesis

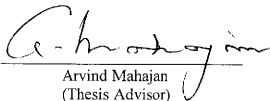
by

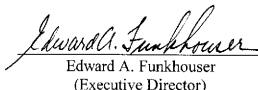
JOSEPH E. BAIN

Submitted to the Office of Honors Programs
& Academic Scholarships
Texas A&M University
in partial fulfillment for the designation of

UNIVERSITY UNDERGRADUATE
RESEARCH FELLOW

Approved as to style and content by:


Arvind Mahajan
(Thesis Advisor)


Edward A. Funkhouser
(Executive Director)

April 2003

Group: Education, Business & Life Science

ABSTRACT

Corporate Social Responsibility and
Its Impact on the Corporate Decision Making Process
for University Undergraduate Research Fellows. (April 2003)

Joseph E. Bain
Department of Finance
Texas A&M University

Fellows Advisor: Dr. Arvind Mahajan
Department of Finance

This study seeks to answer the question, “How does corporate social responsibility (CSR) influence corporate decision making?” It does so in two steps. The first step is the building of a theoretical framework in order to understand the many, vastly different academic theories on CSR. The framework that exists groups thoughts on CSR into three categories, which are as follows: normative stakeholder theory, shareholder wealth maximization theory, and strategic stakeholder theory. Proponents of “normative stakeholder theory” argue that, as a product of society, the corporation should be held accountable to the demands of society, as seen through their various stakeholders. Believers of “shareholder wealth maximization theory” argue that societal utility is maximized as each unit of society seeks to maximize his or her own utility and, therefore, believe that the principles of CSR dictate that the corporation should be held

accountable solely to its shareholders, which are the fundamental owners of the corporation. “Strategic stakeholder theory” is a metaphoric bridge between its two counterparts. Strategic stakeholder theory recognizes that a tradeoff exists for the firm between the immediate wishes of all stakeholders. For the long-term profitability of the firm, strategic stakeholder theory recognizes that both financial and non-financial stakeholders must be acknowledged. The recognition of this tradeoff leads to the second half of this study.

The second part of this study picks up the debate on the relationship between CSR and firm financial performance. It is argued that this relationship is the underlying assumption that separates shareholder wealth maximization theory, which believes that a firm benefits society by seeking its own ends, and normative stakeholder theory, which believes that a firm does not benefit society by seeking profits. To add to the base of knowledge on this topic, a difference of means test is performed on companies that are in the DSI 400, a socially responsive stock index, against companies that are not in the DSI 400. A significant difference was discovered in the attributes measured. It is concluded that the DSI 400 serves as a valid proxy for CSR and further research using the DSI 400 is encouraged.

1. Introduction

Because of recent misdeeds at Enron, Arthur Anderson, World Com, and others, the issue of corporate social responsibility has taken center stage in the media and political arenas. The neglect by corporate executives in the area of corporate social responsibility, or CSR, has resulted in several lawsuits, the two largest bankruptcies in history, and the deterioration of the public perception of corporate America. However, in this time of scrutiny, it is important to recognize that corporate social responsibility is a much broader and far-reaching concept than just the accounting transparency issues behind these corporate scandals.

CSR encompasses not only corporate accountability, but it also includes the corporation's impact on the environment, the moral implications of its business model, and its investment into the surrounding community. Also addressed in CSR are the philanthropic giving of the corporation to the needy of our society, moral issues associated with international corporate investments, and safety issues associated with the corporation's various products. CSR encompasses the entire range of issues that deal with its relationship to society; it is the governing force that outlines this relationship. A lack of socially responsible corporations can have a detrimental effect by allowing the pilfering of societal resources by greedy corporate executives. On the other hand, limited economic resources disallow the corporation to meet every demand of society without infringing on its fiduciary responsibility to its stockholders; a responsibility that comes from the very property rights that underlie our free-market economic system.

This leads to the main question of this study. Namely, does CSR influence corporate decision-making? If it does, how does it do so?

While this inquiry may at first appear simple, this is not the case. In order to effectively answer this question we must first assess current academic theories that define what the relationship between a corporation and its society should be. In other words, what have others defined as being CSR? To do so, a thorough literature review was performed in which the theories were categorized into a three-tiered model that highlights the similarities and differences among the three schools of thought. Each tier or category of literature is thoroughly analyzed for its assumptions and what the assumptions dictate from a corporation in regards to CSR. From this literature review, the relationship between CSR and firm financial performance is discussed. In this discussion, a need for more research on a CSR proxy is discovered. In accordance to this, requirements for a CSR proxy are proposed and the Domini Social Index (DSI 400) is evaluated according to these requirements. The DSI 400 is a socially sensitive stock index, created and managed by the firm KLD Research & Analytics, Inc., that has been used frequently as a proxy for CSR in academic literature. The study ends with some concluding remarks and a proposal for more research to be done that studies the relationship between CSR and corporate financial performance, using the DSI 400 as a proxy for CSR.

area of thought to the ideals behind the World Business Council of Sustainable Development. Moir's (2001) enlightened self-interest is comparable to our "strategic stakeholder theory". Moir (2001) goes on to say that those that argue for a moral approach to CSR "linked to social expectations" argue that "because business has resources and skills there is a quasi-moral obligation to be involved". This group is comparable to our "normative stakeholder theory". Finally, Moir points to the proponents of a neo-classical view of CSR. This view has been most readily identified with the works of Nobel Laureate Milton Friedman who argues "Few trends would so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their shareholders as they possibly can"(Friedman, 1962, p.133). I refer to the neo-classical view as "shareholder wealth maximization theory".

In addition to Moir, the works of Welcomer (2002), Martin (2002), Hillman & Kiem (2001), and Donaldson & Preston (1995) aid in establishing the boundaries of the three tiers. Each of these works highlights the differences between our normative stakeholder theory and strategic stakeholder theory. The use of the term "stakeholder" is owed to Freeman (1984) who defines a stakeholder as "any group or individual who can effect or is affected by the achievement of the organization's objectives" (pg. 46). Welcomer (2002) groups stakeholders into two distinct groups, instrumental stakeholders and normative stakeholders. Instrumental stakeholders are perceived to be stakeholders whom the firm depends on to operate efficiently; while, normative stakeholders possess moral claims on the firm but do not exercise a substantive

influence over the firm's operations. Welcomer (2002) argues, "the instrumental orientation explains firms as addressing stakeholder interests to maximize performance...by contrast, from the normative base, (the firm addresses) those stakeholders who are not perceived to have influence over the firm but have a moral stake in its actions" (pg. 252-3). Welcomer's (2002) instrumental stakeholders are equivalent to our strategic stakeholders.

Martin (2002), Hillman & Kiem (2001), and Donaldson & Preston (1995) also make the distinction between normative and strategic stakeholder theory. The figure below highlights all of these studies and parallels the terms given by each of them to the principles termed "normative stakeholder theory", "strategic stakeholder theory", and "shareholder wealth maximization theory".

Bain (2003)	Normative Stakeholder Theory	Strategic Stakeholder Theory	Shareholder Wealth Maximization Theory
Moir (2002)	"a moral approach linked to social expectations"	"enlightened self-interest"	"neo-classical view"
Hillman and Kiem (2001)	"social issue participation"	"stakeholder management"	
Welcomer (2002)	"normative base"	"instrumental base"	
Martin (2002)	"intrinsic"	"instrumental"	
Donaldson and Preston (1995)*	"normative (use of stakeholder analysis)"	"descriptive (use of stakeholder analysis)" and "instrumental (use of stakeholder analysis)"	

* From Reed (2002)

For our discussion, I have chosen the terms "normative stakeholder theory", "strategic stakeholder theory", and "shareholder wealth maximization theory" with the belief that these terms most accurately describe the three general schools of thought surrounding CSR. The relationship of these terms to one another can be visualized as an old hanging bridge in between two cliffs. The bridge and each one of the cliffs represent a different view on CSR. This bridge metaphor will be referred to repeatedly to demonstrate the relationships between our terms.

One of these cliffs represents normative stakeholder theory, which holds as its basic assumption the belief that the corporation owes its obligation to the society that

The hanging bridge in our metaphor represents our “strategic stakeholder theory”. It connects the two abstract ideas of normative stakeholder theory and shareholder wealth maximization theory by recognizing that a tradeoff exists between financial stakeholders (stockholders, debtors) and non-financial stakeholders (employees, the environment, the local community, etc.). Because this tradeoff is recognized, strategic stakeholder theory represents a conglomerate of ideas from both normative stakeholder theory and shareholder wealth maximization theory. Strategic stakeholder theory is the middle ground of CSR thought; it must be included in our analysis because of the realization that few would take either normative stakeholder theory or shareholder wealth maximization theory at face value. Likewise, strategic stakeholder theory also recognizes that meeting the demands of non-financial stakeholders may carry an intangible benefit, other than just an immediate return to the stockholders, which may be desirable to the firm. The bridge metaphor is beneficial to both understanding the relationship of these three ideas of CSR and to understanding how they relate to CSR’s role in the corporate decision making process. This is described in more detail as a specific analysis of each tier is given below.

2.2. Normative Stakeholder Theory

Normative stakeholder theory is what I have called Moir’s (2002) “moral approach linked to social expectations”, Hillman and Kiem’s (2001) “social issue participation”, and Welcomer’s (2002) “normative base”. This term refers to the school of thought that believes, because the corporation is a creation of society, it is responsible to society. Since the corporation is merely a creation of society, its interests should

(And) it is essential for them to adopt social auditing practices and report to interested parties as to what extent they have fulfilled the social objectives assigned to them” (p. 36). Wilson (2000) argues that “new rules” (which include corporations taking more responsibility for societal concerns) exist in business as the private sector takes over functions traditionally managed by the public sector. Again, the justification for both Batra (1996) and Wilson (2000) is rooted in their ethical convictions for righteousness to society.

In a paper commissioned by the Ford Foundation to examine the study of business ethics in major U.S. business schools, Wood, Davenport, Blockson, and Van Buren III (2002) categorize the methods for teaching CSR (or as they refer to it as “corporate citizenship”) into three approaches (citizenship is charity, citizenship is enlightened self-interest, and citizenship is transforming). Of these three, it is obvious that they advocate the third approach, citizenship is transforming, because of the attention it receives. The citizenship is transforming approach to CSR recognizes the importance that business plays in the life of a society. It is in this recognition that a responsibility to the corporation is derived from. The citizenship is transforming approach argues that if used “corporate involvement in community enrichment, social issues, and related issues would then be viewed as a necessary component of progress toward creating a just society” (p. 224). Again, one should notice the appeal for righteousness.

Reed (2002) is significant and necessary in understanding normative stakeholder theory. Reed’s main purpose is to argue that “the combination of changing

circumstances and additional or supplemental normative principles can increase the responsibilities of corporations acting in developing economies” (p. 184). In doing so, Reed uses the theoretical writings of Jurgen Habermas (Habermas 1975, 1987, 1990, 1993, 1996, 1999) to analyze the stakeholder claims on the firm. According to Reed (2002), the divisions of stakeholders (and their subsequent claims) are as follows: positive / descriptive stakeholders (with claims to truth which are justified through constative discourses), strategic / instrumental stakeholders (with claims of effectiveness and employ pragmatic discourses), and normative stakeholders (with claims of rightness and goodness which are justified through moral and ethical discourses) (p. 169-171). Because of the paper’s focus, the author goes into more detail on normative stakeholders breaking the normative claim into the corporate obligations of ethics, morality, and legitimacy. According to Reed, the ethical obligations of the corporation relate to our understanding of the “good life” and are necessarily related to the specific sociocultural settings in which we have been socialized (p. 173). Moral obligations are universal in nature and refer to the norms to which everyone could agree (p. 173). Legitimacy obligations are also universal in nature and require that the actions of corporations must be based on “broad public discourse” and must develop and conform to a system of rights (p. 174). It is in Reed (2002) that we can see normative stakeholder theory broken down into its fundamental traces. The corporate obligations of ethics, morality, and legitimacy define the ethical justification used within normative stakeholder theory.

The ethical justification inherent to normative stakeholder theory implies a great deal about CSR’s role in the corporate decision making process. If a corporation is

“required to watch the interests of its stakeholders- employees, consumers, shareholders, the general public.... (And) it is essential for them to adopt social auditing practices and report to interested parties as to what extent they have fulfilled the social objectives assigned to them”, as Batra (1996) claims, then we can assume that normative stakeholder theory demands that CSR plays an active part in corporate decision making. In particular, normative stakeholder theory requires that a corporation meet the needs of society as vocalized by a corporation’s stakeholders. In essence, normative stakeholder theory argues that businesses should have a social conscience that should enter into the minds of its managers that creates a guideline for corporate conduct based upon stakeholder demands. Under this guideline, a corporation would have an obligation not to build a factory if doing so gravely harmed the environment, pay lower wages that hurt its employees ability to make a decent living, or produce products (such as alcohol or tobacco) that were viewed by society as unethical. This obligation, again, comes from a corporation’s obligation to society as seen through its stakeholders.

2.3. Shareholder Wealth Maximization Theory

In the earlier mentioned bridge metaphor, shareholder wealth maximization theory is the theoretical “cliff” opposite to normative stakeholder theory. The underlying assumption of shareholder wealth maximization theory is that the only responsibility of a corporation, social or otherwise, should be to maximize its profits given the “basic rules of society, both those embodied in law and those embodied in ethical custom” (Friedman 1970, pg. 33). This is vastly different from normative stakeholder theory, which believes that corporations have a vast array of responsibilities,

both financial and non-financial in nature. The justification for this single responsibility is two-fold. First, this responsibility is based off of the classic economic belief that a society maximizes its utility when each member maximizes his or her own utility, given the absence of market externalities. "Two hundred years of work in economics and finance implies that in the absence of externalities and monopoly (and when all goods are priced), social welfare is maximized when each firm in an economy maximizes its total market value" (Jensen 2001). It is because of the reference to classic economic theory that this school of thought has been dubbed "neo-classical economics". The second argument for a single responsibility by corporate managers has to do with the ownership of the corporation. To explain this, I will use a metaphor. Suppose you were to open up your own bike shop. As your business, all decision-making authority of this bike shop would land on your shoulders. If you wanted to make money by selling cheaper bikes with faulty brakes or start selling beer and cigarettes in the back, you would have a right to do so as long as you obeyed the law and you accepted responsibility for such actions. Likewise, the corporation is a business owned by its shareholders. The managers placed in charge of the daily operations of such businesses are agents of these shareholders and have a responsibility to look out for their interests. It is further argued that if stockholders had wanted to invest their wealth in the building up of society, they have the opportunity to do so by contributing to charitable causes. Because contributing to charitable causes is a more effective method for investing in society, it is assumed that stockholders invest in a corporation for one purpose, to make as much money as possible given the "basic rules of society" (Friedman, 1970) and

given the basic business model presented by the corporation. Using these arguments, proponents of shareholder wealth maximization theory argue that the corporation's sole responsibility to society is to make as much money as possible given societal rules governing its operations and its stated business plan. In doing so the corporation both increases the total utility of society and fulfills its fiduciary responsibility to its shareholders. While normative stakeholder theory makes claims against the principles of ethics, morality, and righteousness (Reed 2002), shareholder wealth maximization theory makes claims against the property rights of shareholders and the principles of liberty and freedom of choice, which are inherent in our free-market economy. The literature within this survey examines this theory from several different perspectives.

As mentioned before, neo-classical economics and, likewise, shareholder wealth maximization theory is most readily identified with the works of Nobel Laureate Milton Friedman. In 1970, Friedman wrote an article for the *New York Times Magazine* entitled "The Social Responsibility of Business Is to Increase Its Profits". This article, in conjunction with his 1962 book *Capitalism and Freedom*, have become the corner stones of shareholder wealth maximization theory. In the article, Friedman argues that

"In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of society, both those embodied in law and those embodied in ethical custom" (p.33)

An underlying assumption of this is that shareholders' only wish for a corporate manager is that he increases their wealth. Friedman addresses this by pointing to the fact that shareholders have the opportunity to contribute money to society by donating it to charity. Because this choice exists, it can be assumed that shareholders entrust their wealth to corporations for the purpose of earning a return on their investment. If a shareholder wanted to contribute to society, he could do so more effectively by contributing to a charitable cause. Corporate managers should, therefore, assume that it is the wish of their shareholders to make as much money as possible given the corporation's business model and the "basic rules of society" and should not allocate corporate assets to charitable causes.

Friedman's argument is also be used as justification for socially questionable companies. Cigarette companies obviously hurt society by producing and marketing a product that has been proven to kill thousands. It has been argued that cigarette companies should stop making money off of a product that kills. According to Friedman's logic, however, cigarette companies should not only continue to make money off of cigarettes but should make as much money as possible within the confines of the law, as long as they are truthful about the risks inherent in the use of their product. Cigarette companies exist because people have invested in them. If the owners of the business didn't want to invest in a business model that ultimately makes a product that has been proven to kill, they could invest elsewhere. Because we as a society have decided to allow the production and sale of cigarettes to be legal and because a group of investors has seen fit to invest in the production of these cigarettes, according to

Friedman, the moral obligation of the cigarette manufacturer's managers is, therefore, to continue to make as much money as possible according to the business model that is described to investors (McCoy et. al., 2000).

Friedman (1970) also argues that CSR expenditures by a corporation represent a forced tax placed on the shareholders and argues that taxation is a function that we have reserved for the government, not for private corporations. Friedman's thoughts (along with those of businessman "Buzz" McCoy, Stanford University Senior Lecturer Kirk Hanson, and Stanford University Professor David Brady) on these issues can be seen in the November 2000 *Stanford Business* forum. In this forum, Friedman comments on his 1970 work by arguing that people have ethics, not business; the ethical decisions of businesses should be made by the owners of the business (in the case of corporations, the shareholders), not the managers. In the case of corporations, it can be assumed that a shareholder wants his managers to make as much money as possible using the business model that the corporation has developed. If this were not the case, the shareholder could always take his money out and invest it in something else. This, of course assumes that the markets are efficient and that the shareholders have all of the information and expertise to understand the corporation's actions.

Harvard Professor *Emeritus* Michael Jensen also comments on CSR (Jensen, 2001). Along the same lines as Friedman, Jensen too argues for shareholder wealth maximization theory using a slightly different focus than Friedman's. Jensen ultimate goal is to argue that shareholders must follow a single corporate objective function. He argues that it is logically impossible for a corporation to maximize two objective

functions and the pursuit to do so weakens the agency relationship that exists between managers and the shareholders. He argues that this single objective function should be the maximization of the corporation's total market value (common stock, preferred stock, debt, and warrants) because economics tells us that societal utility is maximized when each unit seeks to maximize his own utility, which in the case of a corporation means maximizing its economic value as measured by the market. Jensen also argues that the advocates of stakeholder theory "refuse to make the necessary tradeoffs among these competing interests (referring to a corporation's many stakeholders) and they leave managers with a theory that makes it impossible for them to make purposeful decisions" (abstract). Jensen admits that his argument, in reference to utility maximization theory, assumes that there are no market externalities (pg. 303) and that all goods are efficiently priced (abstract).

Also mentioned in the literature review are the works of Bainbridge (2002) and Lantos (2002). Bainbridge (2002) argues against a document put forth by the US Conference of Bishops, which endorses stakeholder theory. In his argument, Bainbridge cites several quotations from Pope John Paul II, which endorse capitalistic economies and condone socialist activities. In doing so, Bainbridge (2002) refers to stakeholder theory as socialistic in nature (p. 32). Similarly, Lantos (2002) argues that CSR activities are actually unethical. He points to several theories on ethics. Specifically, he refers to shareholder property rights as negative or liberty rights and the rights of basic needs of society as positive or welfare rights. Lantos (2002) argues that "most non-utilitarian philosophers believe that liberty rights are more important than welfare rights-

they see us as having a much stronger obligation to refrain from interfering with people's freedoms than to promote their happiness or well being..."(p. 212). Lantos further expands his ethical argument against CSR to include all major areas of philosophy (utilitarianism, rights, justice and care) and concludes that altruistic or normative CSR activities by a public corporation are immoral.

With normative stakeholder theory, we saw that the inherent assumption lead us to conclude that CSR dictates that a corporation yield to the demands society places on it. Because of these demands a corporation is ethically bound not to put its profitability over its social responsibility to its stakeholders. As we have just seen shareholder wealth maximization theory argues that a corporation's only responsibility is its profitability. The underlying assumption of this argument is that by seeking to maximize its own profitability it will leave society (and its stakeholders) better off. As has been discussed, this assumption stems from the classic economic belief that total societal utility is maximized when each individual unit, in this case each corporation, seeks to maximize its own utility. This assumption, which underlies the argument of shareholder wealth maximization theorists, is not held by normative stakeholder theorists. In fact, it is this assumption that ultimately divides these two schools of thought. Both normative stakeholder theory and shareholder wealth maximization theory seek to maximize the utility and well being of the greater society. They are, however, separated by this assumption by shareholder wealth maximization theorists and, therefore, disagree on the means of achieving the maximization of societal utility.

2.4. Strategic Stakeholder Theory

As was stated before, the definition of CSR can be represented by a hanging bridge in between two cliffs. If one cliff were normative stakeholder theory and the other were shareholder wealth maximization theory (two very different theoretical bases), then the bridge in between would be strategic stakeholder theory. What I am suggesting is that not only is strategic stakeholder theory the “bridge” that connects these two opposite ideas, but that there are several different versions of strategic stakeholder theory. Some are closer to normative stakeholder theory; some are closer to shareholder wealth maximization theory. While many different versions of strategic stakeholder theory exist, what identifies a theory as strategic stakeholder theory in this model is the recognition of a tradeoff between non-financial stakeholders and financial stakeholders, and taking both of these groups into account when making decisions. Specifically, strategic stakeholder theory recognizes a tradeoff between different stakeholders and the legitimacy of their claims on the firm along with short-term profits, long-term profits, and risk. Overall, the focus of strategic stakeholder theory is the study of the tradeoffs between shareholders and non-financial stakeholders.

There is a range of studies that I have grouped under the heading “strategic stakeholder theory”. They range from papers that are almost normative stakeholder theory to papers that are almost shareholder wealth maximization theory. I took great effort at discerning which papers belonged in each of these categories. This was especially difficult with strategic stakeholder theory because of the range of views taken. However, there is one characteristic that defines a paper as abiding by strategic

stakeholder theory. All strategic stakeholders recognize a tradeoff between shareholders and other non-financial stakeholders and make their decisions in accordance to this tradeoff. Normative stakeholder theorists, I would argue, may recognize this tradeoff, but ultimately believe that the will of society takes precedence over the corporation's profitability. Shareholder wealth maximization theorists, on the other hand, may recognize a tradeoff, but the will of this group is ultimately decided by what is good for the shareholders. They may take action to improve a relationship with a stakeholder, but only if such action can be directly traced to a creation of wealth to the shareholders (see Jensen, 2001). The distinction between shareholder wealth maximization theory and strategic stakeholder theory is the unwillingness of the latter to allocate corporate resources to benefit non-financial stakeholders. Shareholder wealth maximization theory does not warrant such an allocation unless an observable benefit can be traced to the shareholder. On strategic stakeholder theory, Hillman and Kiem (2001) write:

“Building better relations with primary stakeholders like employees, customers, suppliers, and communities (Freeman, 1984) could lead to increased financial returns by helping firms develop intangible but valuable assets which can be sources of competitive advantage. For example, investing in stakeholder relations may lead to customer or supplier loyalty, reduced turnover among employees, or improved firm reputation. These valuable assets in turn lead to a positive relationship between stakeholder management and shareholder value wherein effective stakeholder management leads to improved financial performance.”

The “intangible but valuable” assets that Hillman and Kiem (2001) discuss are the motivation for taking action from a strategic stakeholder theory perspective.

Shareholder wealth maximization theory would be reluctant to pursue such assets unless they were thought to attribute some direct financial gain to financial stakeholders. There is obviously a fine line between these two groups in this respect but, again, the difference comes from the willingness of advocates of strategic stakeholders theory to recognize and act on the tradeoff they believe to exist between financial and non-financial stakeholders.

A shareholder wealth maximization theorist would never consider donating company funds to a cause that would in no way help the standing of the company, but a strategic stakeholder theorist would consider the implications of this donation and consider what would happen to the stakeholder if they did not donate. Perhaps, a lot of people depend on this cause and it would go under without a little boost. On the other side, while a normative stakeholder theorist would never consider increasing the emissions of its factories, the strategic stakeholder theorist would consider how much money the company would save in doing so and consider what this money could be used for. It may be that the company could increase the emissions of its factories by a negligible amount and then use this money to invest in technologies to increase pollution abatement even further. Again, the group of papers that I have grouped under the heading strategic stakeholder theory all share the distinction of weighing each decision’s implications on both shareholders and other non-financial stakeholders.

As was discussed before, there are a great deal of studies that are grouped under the heading “strategic stakeholder theory”. Following the bridge metaphor, some of them are closer to normative stakeholder theory while others more closely represent shareholder wealth maximization theory. All, however, depend on the tradeoff between financial and non-financial stakeholders and choose to act according to it. Below is a review of the papers that have been termed strategic stakeholder theory. They have been grouped according to one of the following sub-headings: sustainable development, triple bottom line, general theory, strategic stakeholder theory models, and empirical studies. This was done in an effort to group similar arguments together.

2.4.1. Sustainable Development & Triple Bottom Line

Literature on sustainable development and literature on the triple bottom line are similar to normative stakeholder theory. However, what separates them both from normative stakeholder theory is that they leave room for the will of the shareholders to be placed over the will of the general society. In other words, they look at the tradeoffs between shareholders and other stakeholders and act in accordance to this tradeoff. Sustainable development and the triple bottom line approach are, also, both very similar to each other. Sustainable development is defined by the World Commission on Environment and Development as “economic development that meets the needs of the present generation without compromising the ability of future generations to meet their own needs” (Epstein and Roy, 2001). The triple bottom line approach says that a corporation should be held to three bottom lines: financial, environmental, and societal. They are similar in our context because both start from a normative base but move into

looking at the tradeoffs between shareholders and stakeholders. The papers surveyed on sustainable development include a literature review of studies that show that corporate social responsibility can cause firm prosperity (Conference Board, 1999), a presentation of the idea of natural capitalism in which steps are taken so that natural resources are valued properly for the services they provide (Lovins, Lovins, and Hawken, 1999), an article highlighting the one-day business conference entitled "Business Performance and Corporate Social Responsibility" where it was stressed that business and society must co-exist in order to achieve success (Stainer, 2002), an analysis of the drivers of sustainability (Epstein and Roy, 2001), and an agenda for increasing sustainability through the markets (Holliday and Pepper, 2001). The papers surveyed on the triple bottom line include a survey by Sandra Waddock that illustrates the means stakeholders are using to influence corporations and provides a commentary on the triple bottom line (Waddock, 2000) and an analysis on the changing business environment in China and how new opportunities for the triple bottom line are present there (Young and MacRae, 2002).

2.4.2. General Theory

This survey also includes many papers that deal with various theoretical aspects of strategic stakeholder theory. These are important because they provide a basis for understanding strategic stakeholder theory as a whole. Included in this group is Jeff Frooman's 1999 study over stakeholder influence strategies. In this, Frooman uses resource dependency theory to develop a resources relationship in which the strategy used by the stakeholder (direct withholding, direct usage, indirect withholding, and

indirect usage) is determined by its relationship to the firm. This paper is included in the strategic stakeholder theory because it is imperative for the manager to know how the stakeholder will try to influence the corporation when accessing the tradeoff that exists. Also included in this section is a paper by Hess, Rogovsky, and Dunfee (2002), which discusses the emergence of a new form of CSR through strategic corporate initiatives. These CSR actions are distinct from their predecessors because they are more connected to the core values of the firm, more linked to the core competencies of the firm, and are analyzed and communicated to the firm's stakeholders. In this manner, the CSR actions are strategic in that they are done in a manner to promote the welfare of both the shareholders and other stakeholders.

2.4.3. Strategic Stakeholder Theory Models

This sections highlights two academic models that have been grouped in strategic stakeholder theory because of their attempts to understand the tradeoffs present within CSR. The first model is Martin's (2002) "Virtue Matrix". The purpose of this model is to understand the motivation for undertaking CSR; for our purposes, it models strategic stakeholder theory against normative stakeholder theory in order to understand the distinction between the two. This model is a two-by-two matrix that is separated into the "frontier" (the upper two quadrants) and the "civil foundation" (the bottom two quadrants) (see figure below). The "frontier" houses CSR motivations that are originally intrinsically motivated. The "frontier" is separated into the "strategic frontier" and the "structural frontier". The "strategic frontier" houses actions that are done because they help to increase the value to shareholders and benefit society. The

“structural frontier” houses actions that decrease shareholder value. Below the frontier is the “civil foundation” which houses CSR activities that are a part of a society’s norms, expectations, or laws. The “civil foundation” is separated into actions in which firms enter either by “choice” (they choose to acknowledge society’s norms and expectations) or by “compliance” (they are compelled to take a CSR action through legislation). In “The Virtue Matrix”, the “strategic frontier” and the “civil foundation” entered into by “choice” belong to strategic stakeholder theory. Firms enter into these decisions by considering the force of their actions on stakeholders and the effect of those actions on shareholder wealth. Likewise, the “structural frontier” and the “civil foundation” entered into by compliance are normative stakeholder theory principles because these actions do not add value to the shareholder but provide for society; they are, therefore, undertaken for strictly normative reasons.

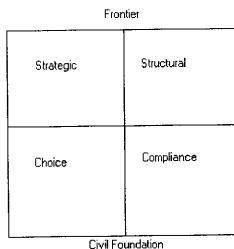


Figure: "Virtue Matrix"

The next model is more cognitive than visual. McWilliams and Siegel (2001) present a model on the CSR activity of embodying products with socially desirable attributes or characteristics. In this context, they argue that CSR can be seen in a supply-demand model in which the demand for CSR activities rests with consumers and CSR is, therefore, supplied by the firm. Thus, consumer demand for CSR attributes is determined by several characteristics of the product. The price of the good with the CSR attribute is said to negatively effect demand, while advertising by the firm, income of the consumer, and price of substitute goods are all said to positively effect the demand of the consumer for the CSR attribute. Tastes and demographics of the consumer base are said to influence demand but do so in an indeterminate way. On the supply side, higher capital expenditures, higher-cost materials and services, and higher wages/ benefits and additional workers are all inputs necessary to increase the supply of CSR attributes. With the increased demand comes increased revenue, but with the increased supply comes increased costs. Because CSR, in this context, can exist within a supply-demand model, McWilliams and Siegel argue that, in this context, there exists a maximum level of CSR where the increased level of revenue equals the higher cost. McWilliams and Siegel argue that, at this point, a firm that produces a product with CSR attributes is just as profitable as a firm that produces a product without CSR attributes. In this manner it is said that CSR and CFP have a neutral relationship. This paper is obviously a strategic stakeholder theory paper in nature, for it attempts to model the tradeoff that exists between the demands of society and the supply that comes from the shareholders. While this model looked at only one instance of CSR (namely, products

with CSR attributes), it provides encouragement that the tradeoffs that exist within CSR can be understood within a rational framework. It is through this attempt that CSR can be seen and understood within the outlines of economics and understood in a rational analysis rather than an appeal to ethics (as in normative stakeholder theory) or an appeal to liberty (as in shareholder wealth maximization theory).

2.4.4. Empirical Studies of CSR

The previous subsection ended with an analysis of the McWilliams and Siegel (2001) model. This model attempted to understand CSR within a logical framework. The studies in this subsection take this a step further. These studies use empirical analysis to not only measure CSR, but to also measure the effect CSR has on the firm. It is in this manner that we are better able to understand the tradeoffs that exist within strategic stakeholder theory. This subsection is the last group of strategic stakeholder theory studies. From the base of previous empirical studies, we will be able to add to the breadth of knowledge by performing our own CSR empirical study in order to further the advancement of future research into the relationship CSR has on a corporation.

The chief question that the empirical analyses in this survey seek to answer is, "What is the relationship of a firm's corporate social responsibility and its financial performance?" The answer to this question has many implications on the operational use of CSR. As was discussed before, the main underlying distinction between normative stakeholder theory and shareholder wealth maximization theory is the assumption by advocates of shareholder wealth maximization theory that by seeking its

maximum profitability, a corporation is leaving society better off. The validity of this assumption is the chief subject of inquiry in empirical research done on the relationship between CSR and firm financial performance. One implication of this assumption is that because a firm benefits society by seeking its own maximum financial performance, firm financial performance and CSR should be positively related. In other words, those firms that are highly profitable should be the most socially responsible according to shareholder wealth maximization theory. Likewise, those firms that are not profitable would be the least socially responsible. The inquiry into the validity of this assumption would therefore create a link between shareholder wealth maximization theory and normative stakeholder theory. Because of this possible link, these studies are grouped under strategic stakeholder theory.

The issue of how to measure CSR is a concern that must be addressed in any empirical investigation on this topic. It is also the subject of the last part of this study in which the validity of a commonly used proxy, inclusion in the Domini Social Index (DSI) 400, is tested for validity and meaning. The DSI 400 will be discussed in detail shortly.

The CSR proxies used in this survey are each characteristically different. It is, therefore, important for this study to identify these proxies and compare their strengths and weaknesses. The proxies in this survey can be broken into three groups. The first group contains proxies that attempt to measure specific aspects of CSR and use this as a proxy for the firm's overall level of CSR. The assumption here is that a firm's performance in one area of CSR is indicative of the firm's general level of CSR. Some

CSR measures that are generally used in this manner are measurements related to a firm's community relations, employee relations, environmental actions, product characteristics, treatment of women and minorities, and the lack of non-CSR activities such as corruption, military contracting, etc. Kumar, Lamb, and Wokutch (2002); Porras, Griswold, and Scott (2002); and Lee and Ng (2002) are all examples of studies that use a single aspect of CSR as a proxy for the firm's general level of CSR.

Kumar, Lamb, and Wokutch (2002) indirectly studied the effects on financial performance of companies that had equity interests in South Africa during the apartheid boycott (a choice by some companies that went against their CSR). The authors use a company's equity presence in South Africa at the time of Nelson Mandela's speech, which effectively ended the call for the South African boycott, as a signal of non-CSR activity. Kumar, Lamb, and Wokutch (2002) showed that after Mandela's speech ended South Africa sanctions, there was an influx of institutional ownership in stocks that had equity interests in South Africa. This proves that institutional investors surged to buy these stocks when sanctions were lifted. It can, therefore, be assumed that institutional investors avoided these stocks and effectively penalized them for not being socially responsible. Furthermore, it is shown that stocks with equity interests in South Africa when sanctions ended were shown to have positive abnormal returns. However, the stocks that had previously announced a withdrawal from South Africa did not show any significant positive abnormal returns.

Porras, Griswold, and Scott (2002) attempt to measure the effect hiring minorities has on a company's prosperity and use a company's presence on *Fortune's*

“50 Best Companies for Minorities” as a screen for CSR. The results presented were inconclusive. Jones and Murrell (2001) use *Working Mother Magazine* in the same fashion, but in this study they use the CSR measure as a general signal for CSR. The results of this study show that firms introduced to the list for the first time did indeed exhibited significant, positive abnormal returns. In addition, the most profound effects were seen in firms listed on the NASDAQ (which the study notes has high liquidity and less intensive information processing compared to the NYSE). Also included in this study is Lee and Ng (2002), which uses Transparency International's Corruption Perception Index (CPI) as a measure of corruption. CPI measures a nation's overall level of corruption. By using this as a proxy, Lee and Ng assume that a corporation within a particular country is destined to descend or ascend to its home country's normal level of corruption. In this manner, Lee and Ng (2002) empirically measure the association of the CPI index to firm value. In doing so, CPI represents Lee and Ng's (2002) CSR proxy. The results of the this study showed that the value of a firm (in the form of its P/E and P/B multiples) is found to be is positively associated to a good CPI ranking of the firm's host country.

The second group of CSR proxies is made of proxies that are specific to a single industry. An example of this is Simpson and Kohers (2002). This paper is a study of the relationship of CSR to corporate financial performance specific to the commercial banking industry. Likewise, the paper uses a CSR proxy that is only applicable to the banking industry. This proxy comes from the Community Reinvestment Act of 1977, which mandates that a bank fulfill the credit needs of their local communities. In

addition, this act puts forth a ranking system to measure how well banks comply with this law. Simpson and Kohers (2002) use this ranking system as proxy for CSR in order to measure the financial performance of higher ranked banks versus the financial performance of lower ranked banks. Simpson and Kohers (2002) found a positive correlation between firm financial performance and CSR.

In addition to specific CSR measures is a third type of CSR proxy; overall CSR proxies that attempt to accumulate the many facets of CSR into one measure. This is done in an attempt to compare companies from an overall CSR perspective and to analyze the general effect CSR has on a company. The most widely used overall CSR measures are the scores given by the firm KLD Research & Analytics, Inc (formerly Kinder, Lydenberg, Domini and Co., Inc.). Currently, KLD scores approximately 800 firms (including those in the S&P 500) in the areas of community relations, employee relations, environment, product characteristics, and treatment of women and minorities on a scale from -2 (major concern) to +2 (major strength). KLD also screens the companies they analyze for activities they deem to be solely undesirable. These activities have included military contracting, participation in nuclear power, profiting off of the sale of alcohol or tobacco, gambling, involvement in South Africa, and non-U.S. concerns over investment in Burma and Mexico. KLD only provides negative scores in these areas. So, KLD scores these firms on a range of -2 (major concern) to 0 (no concern).

The following studies are a sample of the studies in the academic press that have used KLD's scores: Waddock and Graves (1997), Hillman and Kiem (2001), and Ruf,

Muralidhar, Brown, Janney, and Paul (2001), among others. Using this data, Waddock and Graves (1997) found a positive relationship between financial performance and CSR. Hillman and Kiem (2001) divided CSR into issues they deemed as “stakeholder management” (product, employee relations, diversity, community relations, and the environment) and “social issue participation” (alcohol/ gambling/ tobacco, military contracting, nuclear power, non-U.S. operations, and other). They found positive relationship with financial performance among stakeholder management issues and a negative relationship among social issue participation issues. Ruf, Muralidhar, Brown, Janney, and Paul (2001) found that a change in CSR and growth are positively related. However, the positive relation between change in CSR and profitability is not significant and comes later.

In addition to its CSR scores, KLD also produces an index of stocks that have notably high CSR. This market-weighted index is called the Domini Social Index (DSI 400). Inclusion in the DSI 400 is used as a screen for CSR in many studies including McWilliams and Siegel (2000), which assigned each company they analyze with a scoring of wither a “1” (if included in the DSI 400) or a “0” (if not included in the DSI 400). In doing so, McWilliams and Siegel discovered a neutral relationship between CSR and firm financial performance when R&D expenditures are controlled for. The DSI 400 is the main topic of the empirical analysis that follows this section. So, more will be said on KLD and the DSI 400 later in the next section of this study.

The French equivalent to the KLD, the AReSE, scores French companies in the areas of employee relations, the environment, shareholder relations, product quality,

relations with customers, and community on a scale from 1 (backward) to 5 (pioneer). These scores were used in D'Arcimoles and Trebucq (2002) to study the CSR/CFP empirical association in France. They found that their results could not support the hypothesis that higher performance leads to better CSR; it found that (contrary to what was hypothesized) better CSR leads to a lower return on equity. When R&D is controlled for, the relationship between CSR and financial performance becomes neutral.

The role of CSR in the corporate decision making process under strategic stakeholder theory has yet to be addressed. Because strategic stakeholder theory contains many ideas from both normative stakeholder theory and shareholder wealth maximization theory, the role of CSR in corporate decision-making under strategic stakeholder theory depends a great deal upon the perspective that the answering party is coming from. If the party's perspective is in tune with the triple bottom line philosophy that is discussed in Young and MacRae (2002), which consists of corporations being judged for success in the financial, environmental, and community realms, then the answer to this is more inline with normative stakeholder theory; this party would argue that CSR should dictate that firm's fulfill the demands that their perspective stakeholders place upon them. On the other hand, if the answering party follows the logic of the McWilliams and Siegel's (2001) supply-demand model, then the answer to our main question lies more in tune with shareholder wealth maximization theory, namely that CSR considerations should only influence corporate decision making to the point that they increase the profitability of the firm.

3. The DSI 400 as a Proxy for CSR

The relationship of CSR and corporate financial performance is still not clear. In this survey, there are eight studies that indicate a positive relationship, four that indicate a neutral relationship, and two that indicate a negative relationship (Note: Hillman and Kiem, 2001 indicates both a positive and a negative relationship, depending upon what type of CSR is being considered). The book on this is still not closed. There are several reasons for this. First, the addition that CSR may bring to shareholders' value is necessarily a long-term effect. The firm is arguably rewarded for CSR with a stronger commitment to the firm by its stakeholders. This is very difficult to value in a firm's financial statements. In addition is the difficulty in measuring CSR. As was previously discussed many different proxies have been used to measure CSR. Currently there is a need for more research on the validity of these proxies as valid measurements of CSR. In response to this, the last section is dedicated to analyzing the validity and usefulness of one of the most frequently used proxies for CSR, inclusion of a firm in the Domini Social Index (DSI) 400.

The DSI 400, named for one of its founders Amy Domini, was created and is managed by the firm KLD Research & Analytics, Inc. The firm began officially tracking the index on May 1, 1990. The goal of the index is to "(reflect) the behavior of a portfolio of stocks in companies that a socially responsible investor might purchase" in order to "answer the question: How does the application of social criteria affect investment performance?"(KLD.com). KLD is, by far, the most widely used and relied upon source for CSR data and the stocks included in the DSI 400 are carefully selected.

In order to analyze the DSI 400's validity as a proxy for CSR, a thorough analysis of how stocks are selected into the DSI 400 is required. Work began on the DSI 400 in late 1989 to create a stock index that would represent the portfolio of stocks that the typical socially sensitive investor might possess. In order to produce such an index, KLD came up with a system of screens that would eliminate any companies that did not meet a minimum level of CSR. The first set of screens is what KLD refers to as their "exclusionary screens". These screens eliminated companies that:

- Derive 2% or more of sales from military weapons systems.
- Derive any revenues from the manufacture of alcoholic or tobacco products.
- Derive any revenues from gaming products or services.
- Possessed equity interests in South Africa during the apartheid concern (screen was dropped in November 1993 when this concern was no longer relevant).
- Are electric utilities that own interest in nuclear power or derive electricity from nuclear power plants in which they have an interest.

(Courtesy of Domini Social Investments)

In addition, KLD developed a set of qualitative screens that "evaluated companies" records in areas such as the environment, diversity, employee relations and product (KLD has since added a qualitative screen dealing with non-U.S. operations and an "Other" category that addresses executive compensation issues, tax disputes, and companies that own a sizeable portion of a socially questionable company). KLD made

an effort to exclude companies whose records were, on balance, negative in these areas and to include companies whose records were, on balance, positive in these areas. Problems in one area did not automatically eliminate a company. KLD instead sought to balance the mixed records of concerns and strengths that companies often have within these areas” (Domini.com). The index was set at the common stock of 400 publicly traded corporations. To meet this 400, KLD initially turned these screens onto the S&P 500. These standards eliminated approximately half of the S&P 500 from inclusion in the DSI 400 (KLD also eliminated S&P companies with stock prices below \$5 per share and firms with serious financial troubles that cast doubt on their long-term viability). KLD then sought non-S&P companies with large market capitalization and industry representation and passed them through the same criteria. The DSI 400 acquired another 100 corporations through this means. KLD then added 50 more companies known to possess “exceptional social characteristics” that also passed KLD’s criteria to be included in the DSI 400. In monitoring companies KLD used (and continues to use) a broad range of sources, including the following:

- Annual reports, 10K forms, proxy statements, and quarterly reports.
- Specific issue reports.
- The business media (articles in *Fortune*, *Business Weekly*, *Wall Street Journal*, *Forbes*, etc.), trade journals, and the general media.
- Relevant articles from periodicals such as *Chronicle of Philanthropy*.
- Regional Environmental Protection Agency Newsletters.
- Academic journals.

- The *National Law Review*.
- External Rankings such as *Working Mother's* listing of the best companies for women to work for.
- A yearly questionnaire sent by the KLD staff to each company's investor relations office about CSR practices and a follow-up with those offices to assure accuracy.

(Waddock and Graves, 1997)

Since then, the DSI 400 has continued to include a constant 400 companies. The index is market-weighted, similar to the S&P 500. KLD meets bi-monthly to review the companies in the index to determine if any company should be dropped from the DSI 400 and, if so, what its replacement should be. One of the goals of KLD is to keep turnover of the DSI 400 to a minimum; it has averaged only a 6-8% turnover over the past five years. With this in mind, the most common reason for a company to be removed from the DSI 400 is because it ceases to exist. By this it is meant that the company is either acquired by another firm, split into two or more companies, has entered into bankruptcy proceedings, or has ceased to operate as its former entity. Despite KLD's low turnover, it must occasionally remove a stock from the DSI 400 for social reasons. Historically, no more than one or two companies have been removed per month for social reasons. If a company is removed for social reasons, KLD does not consider re-adding the company for two years. The screens by which companies are continuously evaluated after being admitted to the DSI 400 are almost identical to the original screens used to construct the index. The only difference lies in an adaptation of

the screens to the current social conscious of the investing community. Changes to the screens were previously noted above. After admitted to the DSI 400, “if a company... becomes involved in an industry excluded from the DSI (through the exclusionary screens), KLD drops the company as soon as it can verify that the company violates the screen. KLD moves more cautiously in removing a company involved in a controversy covered by a qualitative screen. In such cases, KLD waits until it can determine whether a controversy is substantial and likely to persist for more than a year” (KLD Decision Series, “Starbucks’ Relationship with Kraft Foods”). In determining whether or not a concern covered under a qualitative screen is substantial enough to remove it from the DSI 400, KLD judges the problem along the following five factors:

- Magnitude of the problem.
- Company response.
- Patterns of problems at the company.
- Industry considerations.
- Casual link between product and problem.

(KLD Decision Series, “Odwalla, Inc., and the Domini Social Index Process”)

When a firm is involved with a controversy involving a qualitative issue, KLD uses these guidelines to judge whether or not the underlying problem behind that controversy is both substantial and long lasting in nature. KLD uses extreme discretion in removing companies from the DSI 400 for issues related to its qualitative screens. Since 1998,

KLD has only removed a total of fifteen companies from the DSI 400 for qualitative related reasons.

This analysis leads to the meaning behind a firm's stock being in the DSI 400. The easiest way for a company to be removed from the DSI 400 is to become involved with an industry prohibitively banned by the exclusionary screens. These industries include the production of alcohol, tobacco, military weapons, gambling, nuclear power, or (until November 1993) having equity interests in South Africa. This list represents the industries that the typical socially conscious investor would avoid. The qualitative screens are less concrete and rarely play a role in a company being removed from the DSI 400. A company will not be removed from the DSI 400 for qualitative reasons unless the controversy surrounding it is severe and long lasting. Such a controversy would likely be detrimental to a company's appearance to socially sensitive investors and would thus be avoided. The effect of a mild controversy is less determinable and does not play a part in this analysis. In short, the companies whose stocks make up the DSI 400 are those companies that are not avoided for social reasons by socially conscious investors. This is the meaning behind the DSI 400.

For our purposes as a proxy for CSR, the DSI 400 should possess three qualities. It should be highly accepted, universally applicable, and possess valid meaning. The term "highly accepted" is self-explanatory and refers to the proxy's broad use and acceptance by the academic community. Abramson and Chung (2000), D'Antonio, Johnssen, and Hutton (1998), Statman (2000), McWilliams and Siegel (2000), and others have all specifically used inclusion on the DSI 400 as a proxy for CSR. It is

assumed, therefore, that this criterion is met. The proxy, for our purposes, should also be universally applicable. There is much academic debate on this. Carroll (2000) argues that in order for a measure to be called CSR, it should necessarily include all facets of CSR. However, Rowley and Berman (2000) argue that multidimensional constructs, such as the DSI 400, necessarily skew conclusions drawn upon them because “by aggregating multiple dimensions into a composite measure, much of the meaning and richness in the data is lost” (p. 403). Ruf, Muralidhar, and Paul (2001) also comment on the inaccuracies created by using a single measure to accommodate for a multidimensional construct and propose a measure of CSR based upon the managerial concept of the Analytic Hierarchy Process. The goal of this study is to answer the question, “How does CSR impact the corporate decision making process?” This question is asked in a general sense, in hopes that it will provide corporate executives guidance in discerning between available alternatives in choosing where to allocate corporate assets. Because this question is asked in a general sense, we seek must seek a proxy that includes all aspects of CSR. The ability to determine whether or not CSR is related to CFP in narrower contexts, which would necessitate a more specific proxy, is available, but such a revelation would provide little guidance in analyzing CSR’s overall role in the corporate decision making process. Our ideal proxy, therefore, must be universally applicable. Because of the consideration of such a large range of issues (everything from alcohol to diversity), assuming universal application of the DSI 400 is appropriate.

Our ideal proxy must also possess valid meaning. By this, I simply mean that our proxy must indicate a firm's level of CSR; companies in the DSI 400 should be distinctively more socially responsible than companies not in the DSI 400. By using inclusion in the DSI 400 as a proxy for CSR, as McWilliams and Siegel (2000) does, we rely on this to be true for the DSI 400. To determine the validity of the DSI 400 as an appropriate CSR proxy, a difference of means test is performed on companies in the DSI 400 against companies not in the DSI 400. Our data set is all available CSR data by KLD from 1991-1996. Below is a table listing the number of companies that KLD scored in each year of our study.

Year	Number of Companies		
	Total	DSI	Non-DSI
1991	647	400	247
1992	652	400	252
1993	651	399	252
1994	643	399	244
1995	647	400	247
1996	651	400	251

It should be noted that because KLD keeps a continuous 400 companies in the DSI 400, in each of the above years, four hundred of the companies would be expected to be in the DSI 400; the remainder we would expect to be "Non-DSI companies". However, within our empirical analysis, it was discovered that for 1993 and 1994 only 399 companies out of our data were in the DSI 400; the remaining balance were "non-DSI companies". It could be possible that our data is incomplete or that this is due to a

clerical error. Nonetheless, within our data set of more than 640 companies for each year, it is assumed that the given data is adequate to determine any differences between companies in the DSI 400 (“DSI companies”) and companies not in the DSI 400 (“Non-DSI companies”).

The data used are the scorings published by KLD. KLD scores the following on a scale of -2 to +2:

- Community Relations (1991-1996)
- Diversity (1995-1996)
- Employee Relations (1991-1996)
- Environment (1991-1996)
- Non-U.S. Operations (1994-1996)
- Product (1991-1996)
- Women & Minority Treatment (1991-1994)
- Other (1991-1996)

These are the same criteria used as qualitative screens in creating the DSI 400. The “Other” category contains such items as executive compensation issues, tax issues, and ownership concerns. The years listed beside each category list the years in which KLD assessed companies on that particular attribute. KLD attempts to continually adjust its methods to make them more accurately portray the values of society. For instance, in 1995 KLD switched from assessing companies on their treatment of women and minorities and began assessing companies on the overall level of diversity present in

their workforce. This is a subtle change but one that more accurately reflects the views of society. These items correspond to the qualitative screens as discussed above.

In addition, KLD scores the following from a scale of -2 to 0:

- Alcohol, Gambling, & Tobacco (1995-1996)
- Military Contracting (1991-1996)
- Nuclear Power (1991-1996)
- Investment in South Africa (1991-1993)

These are the same criteria used as exclusionary screens in creating the DSI 400. The significance of not assigning positive scores to these categories is that it is KLD's belief that participation in any of these activities can only have a negative affect on a company's relationship to society. Again the years listed represent the years in which KLD assessed each particular attribute.

A difference of means test was chosen because it presented the simplest method for ascertaining a significant difference between DSI companies and non-DSI companies. If the DSI 400 truly stands as a valid proxy for CSR then it should stand that DSI companies should score significantly better (i.e. more positively) than non-DSI companies. As can be seen in the data below, this is the case.

	Com. Rel.	Diversity	Emp. Rel.	Environment
DSI	0.4491	0.3775	0.2636	0.1076
Non-DSI	0.2840	0.1566	-0.1098	-0.5084
Difference	0.1651	0.2209	0.3734	0.6160

	Non-US Ops.	Product	W&M	Other
DSI	-0.0067	0.1068	0.2322	-0.1439
Non-DSI	-0.0836	-0.4039	0.0693	-0.3436
Difference	0.0769	0.5106	0.1628	0.1997

	AGT	Military	Nuclear	S. Africa
DSI	-0.0025	-0.0471	-0.0054	-0.0108
Non-DSI	-0.1205	-0.4849	-0.2405	-0.4820
Difference	0.1180	0.4378	0.2350	0.4712

The data shows that in every single attribute, DSI companies perform significantly better than non-DSI companies. This is what we were expecting. Using the DSI scores we have determined that the companies in the DSI 400, at least from

1991-1996, were significantly more socially responsible than companies not in the DSI 400. From this data, we can conclude that a company's designation as being in the DSI 400 implies a certain minimum level of CSR that is higher than the minimum level of CSR expected from a company that is not on the DSI 400. This opens the door for future research using the DSI 400 as a valid proxy for CSR.

Also worth discussion is the selection of attributes in which the difference between the mean of the DSI companies was significantly higher than the Non-DSI companies. This was especially seen in the following attributes: environmental issues, product issues, military contracting issues, and issues pertaining to South Africa. It can be assumed that from this we can gather that these issues were taken up most frequently by DSI companies as important CSR initiatives. In contrast to this, those issues that demonstrate a particularly low difference are Non-US operations, alcohol/ gambling/ tobacco, treatment of women and minorities, and community relations. It can be concluded that corporations did not consider signifying themselves as leaders in these areas as important as signifying themselves as leaders in the high difference issues.

4. Summary and Conclusions

Because of the mass of information contained in this study, I will begin by highlighting the key points. The overall goal of this study has been to investigate the role that CSR plays in corporate decision-making. What we saw was that this answer depends on the frame of reference of the one answering this. A three-tiered theoretical model is proposed to classify the differing schools of thought on this issue. In this model, the two purely theoretical views are normative stakeholder theory and shareholder wealth maximization theory. Normative stakeholder theory believes that corporations must fulfill the demands that society places upon it. These demands are seen through the corporation's many stakeholders. Opposed to this, shareholder wealth maximization theory argues that managers should see the maximization of the corporation's value as their only objective. Assumed is that by seeking to maximize its own value, the corporation is leaving society better off. From these two theoretical bases, we moved to the more application-based strategic stakeholder theory, which recognizes a tradeoff between financial and non-financial stakeholders and acts according to this tradeoff. Of particular interest were the strategic stakeholder theory studies that sought to discover the relationship between CSR and firm financial performance. There is not yet a substantial conclusion on the relationship between CSR and financial performance. One reason for this is a lack of research on an appropriate CSR proxy. In accordance to this, this study ended with an evaluation of the DSI 400 as a proxy for CSR. It was concluded that the DSI 400 stood as a valid proxy for CSR.

The concept of corporate social responsibility is both highly ambiguous and extremely dependent on the individual. My definition of CSR is no doubt different than yours. My beliefs are completely based off of my perceptions and past experiences, as are yours off of your perceptions and past experiences. This makes the study of CSR extremely difficult, but not impossible. The model proposed in this study allows all beliefs to be understood in the context of our theoretical bases, normative stakeholder theory and shareholder wealth maximization theory. Therefore, it is imperative to understand the differences that separate these two beliefs. The fundamental difference is the assumption by shareholder wealth maximization theory that a corporation by seeking its own maximum value, leaves society better off. Advocates of normative stakeholder theory do not share this assumption.

This, of course, leads to a study of the relationship of CSR and firm financial performance. If a corporation benefits society by seeking its own financial ends, then it stands to reason that a positive relationship should exist between CSR and firm financial performance. If there is no such relationship, serious doubt is cast on this assumption and, likewise, on shareholder wealth maximization theory. One problem was there is currently a lack of research on CSR proxies. In response to this, a difference of means test was applied to companies in the DSI 400 from 1991-1996 against companies not in the DSI 400 according to CSR scores given by KLD. Our results lead to the conclusion that the DSI 400 stands as a valid proxy of CSR.

This study is merely the first step. More research is needed on the relationship between CSR and firm financial performance. This study merely gives justification for

using the DSI 400 as a proxy for CSR. Future studies should use this information to continue to explore the relationship between CSR and financial performance in order to make future conclusions on the role of CSR in corporate decision-making.

References

- Abramson, L., Chung, D., 2000. Socially responsible investing: viable for value investors?, *Journal of Investing* 9, 73-80.
- Bainbridge, S.M., 2002. The bishops and corporate stakeholder theory, *Villanova Journal of Law and Investment Management*, forthcoming.
- Baron, D.P., 2001. Private politics, corporate social responsibility, and integrated strategy, *MIT Journal of Economics and Management* 10, 7-45.
- Basso, A., Funari, S., 2002. Measuring the performance of the ethical mutual funds: a DEA approach, Unpublished paper, University of Venice, Venice, Italy.
- Batra, G.S., 1996. Dynamics of social auditing in corporate enterprise: a study of the Indian corporate sector, *Managerial Auditing Journal* 11, 36-45.
- Boehm, A., 2002. Corporate social responsibility: a complementart perspective of community and corporate leaders, *Business and Society Review* 107, 171-194.
- Carroll, A.B., 2000. A commentary and an overview of key questions on corporate social performance measurement, *Business & Society* 36, 466-478.
- Conference Board, The, 1999. The link between corporate citizenship and financial performance.
- D'Antonio, L., Johnssen, T., Hutton, R.B., 1998. Socially responsible investment: is it profitable?, *The Investment Research Guide to Socially Responsible Investing, The Colloquium on Socially Responsible Investing*.
- D'Arcimoles, C.H., Trebuq, S., 2002. The corporate social performance- financial performance link: evidence from France, Unpublished paper.
- Dhran, B.G., 2002. Enron's accounting issues – what can we learn to prevent future Enrons. Prepared statement presented to the US House Committee on Energy and Commerce. US House of Representatives, Washington, D.C.
- Donaldson, T., Preston, L.E., 1995. The stakeholder theory of the corporation: concepts, evidence, and implications. *Academy of Management Review* 20, 65-91.
- Epstein, M.J., Roy, M., 2001. Sustainability in action: identifying and measuring the key performance drivers, *Long Range Planning* 34, 585-604.
- Freeman, R.E., 1984. *Strategic Management: A Stakeholder Approach*, Pitman, Boston, MA.
- Friedman, M., 1962. *Capitalism and Freedom*, University of Chicago Press, Chicago, IL.
- Friedman, M., 1970. The social responsibility of business is to increase its profits, *New York Times Magazine*, 122-126.
- Frooman, J., 1997. Socially irresponsible and illegal behavior and shareholder wealth, *Business & Society* 36, 221-249.
- Frooman, J., 1999. Stakeholder influence strategies, *Academy of Management Review* 24, 191-205.
- Griffin, J.J., Mahon, J.F., 1997. The corporate social performance and corporate financial performance debate: twenty-five years of incomparable research. *Business and Society* 36, 5-31.
- Habermas, J., 1975. *Legitimation Crisis*, Beacon Hill, Boston, MA.

- Habermas, J., 1987. *The theory of communicative action*, Beacon Hill, Boston, MA.
- Habermas, J., 1990. *Moral consciousness and communicative action*, Polity, Cambridge, UK.
- Habermas, J., 1993. *Justification and application: remarks on discourse ethics*, MIT Press Cambridge, MA.
- Habermas, J., 1996. *Between facts and norms: Contributions to a discourse theory of law and democracy*, MIT Press, Cambridge, MA.
- Habermas, J., 1999. *The European nation-state and the pressures to globalization*. *New Left Review*, 46-59.
- Hardjono, T.W., Marrewijk, M., 2001. *The social dimensions of business excellence*, *Corporate Environmental Strategy* 8, 223-233.
- Heald, M., 1957. *Management's responsibility to society: the growth of an idea*, *Business History Review* 31, 375-384.
- Hess, D., Rogovsky, N., Dunfee, T.W., 2002. *The next wave of corporate community involvement: corporate social initiatives*, *California Management Review* 44, 110-125.
- Hillman, A.J., Keim, G.D., 2001. *Shareholder value, stakeholder management, and social issues: what's the bottom line?*, *Strategic Management Journal* 22, 125-139.
- Holliday, C., Pepper, J., 2001. *Sustainability through the market: seven keys to success*, World Business Council for Sustainable Development.
- Jensen, M.C., 2001. *Value maximisation, stakeholder theory, and the corporate objective function*, *European Financial Management* 7, 297-317.
- Jones, R., Murrell, A.J., 2001. *Signaling positive corporate social performance*, *Business & Society* 40, 59-78.
- Kumar, R., Lamb, W.B., Wokutch, R.E., 2002. *The end of South African sanctions, institutional ownership, and the stock price performance of boycotted firms*, *Business & Society* 41, 133-165.
- Lantos, G.P., 2002. *The ethicality of altruistic corporate social responsibility*, *Journal of Consumer Marketing* 19, 205-230.
- Lee, C.M., Ng, D.T., 2002. *Corruption and international valuation: does virtue pay?*, Unpublished paper, Cornell University, Ithaca, NY.
- Lovins, A.B., Lorins, L.H., Hawken, P., 1999. *A road map for natural capitalism*, *Harvard Business Review*, May-June 1999, 145-158.
- Martin, R.L., 2002. *The virtue matrix: calculating the return on corporate responsibility*, *Harvard Business Review*, March 2002, 67-75.
- McCoy, B., Hanson, K., Brady, D., Friedman, M., 2000. *A question of ethics: a spirited discussion on the complex relationship between business and social responsibility*, *Stanford Business*, 69, <www.gsb.stanford.edu/community/bmag/sbsm0011/feature_ethics1.html>
- McWilliams, A., D. Siegel, 2000. *Corporate social responsibility and financial performance: correlation or misspecification?*, *Strategic Management Journal*, 21, 603-609.

- McWilliams, A., Siegel, D., 2001. Corporate social responsibility: a theory of the firm Perspective, *Academy of Management Review*, 26, 117-127.
- Moir, L., 2001. What do we mean by corporate social responsibility?, *Corporate Governance* 1, 16-22.
- Moore, G., Corporate social and financial performance: an investigation in the U.K. supermarket industry, *Journal of Business Ethics* 34, 299-315.
- OECD, 2001. Corporate social responsibility: partners for progress.
- OECD, 2001. Corporate social responsibility: private initiative and public goals.
- Orlitzky, M., 2001. Does firm size confound the relationship between corporate social performance and firm financial performance?, *Journal of Business Ethics* 33, 167-180.
- Orlitzky, M., Benjamin, J.D., 2001. Corporate social performance and firm risk: a meta-analytic review, *Business & Society* 40, 369-396.
- Pfeffer, J., Salancik, G.R., 1978. *The external control of organizations*. Harper & Row, New York, NY.
- Porras, D., Griswold, M.C., Scott, B.G., 2002. Fortune's 50 best companies for minorities: does diversity pay?, Unpublished paper, Quincy University, Quincy, IL, Webster University, St. Louis, MO.
- Reed, D., 2002. Employing normative stakeholder theory in developing countries- a critical theory perspective, *Business & Society* 41, 166-207.
- Riahi-Belkaoui, A., 1999. *Corporate social awareness and financial outcomes*, Quorum Books: Westport, CT.
- Roman, R.M., Hayibor, S., Agle, B.R., 1999. The relationship between social and financial performance, *Business and Society*, 38, 109-125.
- Rowley, T., Berman, S., 2000, A brand new brand of corporate social performance, *Business & Society* 39, 397-418.
- Ruf, B.M., Muralidhar, K., Brown, R.M., Janney, J.J., Paul, K., 2001. An empirical investigation of the relationship between change in corporate social performance and financial performance: a stakeholder theory perspective, *Journal of Business Ethics* 32, 143-156.
- Ruf, B.M., Muralidhar, K., Paul, K., 1998. The development of a systematic, aggregate measure of corporate social performance, *Journal of Management* 24, 119-133.
- Saaty, T.L., 1980. *The analytic hierarchy process: Planning, Priority Setting, Resource Allocation*, McGraw Hill, New York, NY.
- Simpson, W.G., Kohers, T., 2002. The link between corporate social and financial performance: evidence from the banking industry, *Journal of Business Ethics* 35, 97-109.
- Stainer, A., 2002. Business performance & corporate social responsibility, *Management Services* 46, 36-39.
- Statman, M., 2000. Socially responsible mutual funds, *Financial Analysts Journal*.
- Waddock, S.A., 2000. The multiple bottom lines of corporate citizenship: social investing, reputation, and responsibility audits, *Business and Society Review* 105, 323-345.

- Waddock, S.A., Graves, S.B., 1997. The corporate social performance- financial performance link, *Strategic Management Journal*, 18, 303-319.
- Welcomer, S.A., 2002. Organizational response to external influence and organizational philosophy, *Business & Society* 41, 251-257.
- Wilks, N., 2002. Good behaviour is its own reward, *Professional Engineering*, May, 36-37.
- Wilson, I., The new rules: ethics, social responsibility and strategy, *Strategy & Leadership* 28, 12-16.
- Windsor, D., 2001, "Corporate social responsibility: a theory of the firm perspective"- some comments, *Academy of Management Review* 26 502-3.
- Wood, D.J., Davenport, K.S., Blockson, L.C., Van Buren III, H.J., 2002. Corporate involvement in community economic development, *Business & Society* 41, 208-241.
- World Commission on Environment and Development, 1987, *Our common future*, Oxford University Press, Oxford, UK.
- Young, N., MacRae, P., 2002, Three "c's: civil society, corporate social responsibility, and China, *The China Business Review* 29, 3.

VITA
JOSPEH E. BAIN

3908 Hilltop Drive, Bryan, Texas 77801
joebain03@yahoo.com

Education

1999-2003 Texas A&M University College Station, Texas
BBA in Finance

Academic Honors

- *Magna Cum Laude*
- University Undergraduate Research Fellow
- Phi Kappa Phi (elected senior year)
- Institutional Nominee for the George J. Mitchell Scholarship
- Summer University Undergraduate Research Fellows Scholarship
- Mays Business School Dean's Honor Roll (Fall '01, Spring '02 & Spring '03)
- Dwight Look College of Engineering Dean's Honor Award (Spring '00)
- Nuclear Engineering Letter of Commendation
- Featured in *The National Dean's List*
- National Society of Collegiate Scholars
- Nominated for Golden Key International Honour Society

Professional Experience

2003	Dell Computer Corporation Financial Analyst	Round Rock, Texas
2002	Universal Computer Systems, Inc. Software Analyst	College Station, Texas
2001	George Bush Presidential Library Student Intern – Archivist Aide	College Station, Texas

Volunteer Activities (Leadership Positions):

- St. Mary's Pastoral Council
 - Appointed to Ethics and Integrity Committee
 - Appointed to Leadership Training Institute Planning Committee
- Retreat Leader, Saint Mary's Youth Retreat Team
- Group Leader, Aggie On-Campus Bible Study
- Staff Head, Group Leader, and Logistics Coordinator, Aggie Awakening
- Group Leader and Speaker, Crossroads Awakening