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# Corporate social responsibility and shareholder's value ☆

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ABSTRACT

Corporate social responsibility (CSR) has become one of the core components of corporate strategy and a crucial instrument to minimize conflicts with stakeholders. While corporations are busy adopting and enhancing CSR practices, the academic literature on understanding the impact of CSR is scarce, especially in the capital market. This paper traces the market reaction to corporate entry and exit from the Domini 400 Social Index, recognized as a CSR benchmark, between 1990 and 2004. The results reveal a significant negative effect on abnormal returns after exit announcements from the Domini index. The effect persists even after controlling for concurring financial distress shocks and stock market seasonality.



## 1. Introduction

Recent financial scandals – e.g. Enron, Parmalat, and WorldCom – and, more recently, the global financial crisis are forcing corporate executives to contemplate a broader strategy beyond a focus on stockholders' wealth maximization. A general understanding is emerging that the reputation of a company and the welfare of distinct stakeholders are crucial to stockholders' wealth maximization and long-term survival. In such scenarios, the ultimate value of shareholder wealth may be linked to "maximizing *the sum of various stakeholder surpluses*." Studies by Geczy, Stambaugh, and Levin (2005) and Bauer, Koedijk and Otten (2005) reveal that investors are equally interested in such initiatives, as documented by the increased flow of funds into ethically managed mutual funds. One in nine dollars invested in the market is invested in "socially responsible" portfolios (see Report on Socially Responsible Investing trends in the United States, 2003 and Cerulli Associates' European SRI Reports). Similar trends prevail in Europe where the number of socially screened mutual funds has nearly doubled recently, mainly in the United Kingdom, Sweden, France and Belgium. Most studies in the business literature are focused on the performance (Orlitzky, Schmidt and Rynes, 2003), risk (Orlitzky and Benjamin, 2001) or strategic implications (McWilliams, Siegel, & Wright, 2006) associated with corporate social responsibility. Except for Doh, Howton, Howton, and Siegel (2010), the literature lacks studies on the capital market reaction to socially responsible actions/non-actions by corporations.

Doh et al. is the first published paper to reveal that investors care about a firm's commitment to social activities. The authors find a significant impact of exits (but not of entries) and suggest that future research should verify whether their findings on a specific sample and limited time period may be extended to other CSR indexes. Our paper follows this direction by investigating the change in equity market value of companies following or rejecting CSR activities. We investigate a stock market index of social responsibility, the Domini 400 Social Index, while evaluating the stock price impact of inclusion in and deletion from the index. Entries into or exits from the index are announced by the Domini 400 the same day the event occurs.

We hypothesize that investors track socially responsible companies and indices, and that any substantial change announcement in the index is reflected in the abnormal return of these firms in the capital market. Employing an event study analysis during 1990–2004, we measure the net effect of CSR index entry and exit. We find a significant negative effect on abnormal returns after announcements of exit from the Domini index. This negative relation persists even after controlling for concurrent financial distress shocks and stock market seasonality.

The remainder of the paper is organized as follows. Section 2, briefly summarizes the key theoretical and empirical literature.

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Section 3 reports the data, methodology and results, along with a series of robustness checks. The final section concludes the paper.

## 2. CSR and corporate performance: the state of the art

Stock market prices should reflect fundamental value, i.e. the discounted sum of the expected dividends accruing to shareholders. When investors are rational and fully informed, expected values are instantaneously revised with the arrival of news that affects factors determining the fundamental value of the stock (expected future cash flows, interest rates, risk premia, stock betas, etc.). Thus, the impact of events, such as entries into or exits from the Domini 400, should be predictable based on a theoretical framework that evaluates the impact of the event itself on the different components of the formula of the fundamental value of the stock.

A crucial issue to consider when formulating our hypothesis on the effects of the announcement of an event related to the CSR choice is the investigation of the nexus between corporate social responsibility and corporate performance, and, more specifically in our case, the specific criterion of corporate performance represented by shareholder value.

Kinder, Lydenberg and Domini Research & Analytics, Inc. (KLD) divide the CSR criteria analyzed for inclusion in the Domini Index into eight broad categories: i) *community*; ii) *corporate governance*; iii) *diversity*; iv) *employee relations*; v) *environment*; vi) *human rights*; vii) *product quality*; and *controversial business*. For each of them, the KLD identifies strengths and weaknesses, and indicates a series of corporate actions falling under one of the two categories. Overall, we find that most of the strengths and weaknesses in each of the eight domains are cost increasing, with the notable exception of the *product quality* section, and of rules limiting managerial compensation (in the *employee relations* section). Hence, we may be led to conclude that most of the SR criteria (see in particular those in the *employee relations*, *environment*, *community* and *human rights* sections) involve a *shift of focus* from the maximization of shareholder value to the satisfaction of the interests of a broader set of stakeholders (shareholders but also local communities, workers, domestic and foreign subcontractors).

On the other side, we must nonetheless consider that the CSR choice may have positive effects on market value by enhancing workers' productivity, especially when it involves wage and non-wage benefits for firm employees. The productivity-enhancing effect of such benefits is widely analyzed by the efficiency wage literature (Yellen, 1984) in shirking (Shapiro & Stiglitz, 1984) and gift exchange models (Akerlof, 1982). Furthermore, the importance of intrinsic motivations in productivity and the availability of workers who accept lower wages (and even voluntary work) when the intrinsic motivations are strong suggest that the latter are partial substitutes for pecuniary transfers (Frey & Oberholzer-Gee, 1997; Kreps, 1997; Ryan, Koestner, & Deci, 1991). Therefore, intrinsic motivations are a channel through which corporate social responsibility may reduce costs and increase productivity by fostering alignment between corporate goals and employee motivations. Another "value-increasing" argument is set forth by Freeman (1984), who considers that CSR may be an optimal choice to minimize transaction costs and potential conflicts with stakeholders. From this perspective, CSR may be seen as an effective tool for improving firm reputation and reducing the risk of remaining victims of consumer activism and legal actions. Finally, CSR firms are increasingly enjoying market support from "ethically responsible" consumers whose perception of firm ethicality significantly affects their consumption and investment choices (Becker-Olsen, Cudmore, & Hill, 2006; Shea, 2010).

The nexus between CSR and corporate performance is thus complex and its complexity is confirmed by the empirical literature in the field, which does not provide clear-cut results. The limitation common to most of these papers is in the adoption of estimation techniques that do not take into account problems of endogeneity and stationarity of time series and panel data.

A more recent vintage of papers refines, significantly, the empirical methodology, and presents interesting findings. Among them, Barnea and Rubin (2005) demonstrate that the decision to invest in CSR is negatively related to insider ownership and interpret this finding in the light of an overinvestment hypothesis. Bauer, Koedijk, and Otten (2002) compare active strategies of ethical and traditional investment funds, finding mixed results (not univocal prevalence of one over the other), but observe a learning process that gradually improves the performance of ethical investment fund managers. Geczy, Stambaugh and Levin (2003) calculate the cost of imposing socially responsible investment constraints in terms of risk-adjusted returns and show their dependence on the share of SR investment, on views about asset-pricing models (SR funds are less able to offer exposure to size and value factors than to the standard one CAPM factor) and on the ability of stock managers.

In the management literature, a number of studies focus on linking corporate social activities to firm strategies and performances (Crane, McWilliams, Matten, Moon, & Siegel, 2008; Fowler & Hope, 2007). Some studies also show that "corporate social responsibility firms" can even be rewarded in the capital market. Based on the institutional theory, Doh, Howton, Howton and Siegel (2009) show that a firm's addition to or deletion from a social index does matter, although it is more important for deletion. We follow the above-mentioned theoretical and empirical considerations and we expect different, and potentially conflicting, effects of addition to and deletion from the Domini index. If the *shift of focus* hypothesis holds (and the cost-increasing dominate over the cost-decreasing effects), we should expect a negative (positive) abnormal return in the case of an addition (deletion) announcement.

As already observed and determined in the balance sheet data, one of the main limitations of all the analyses is the difficulty of controlling for endogeneity. In the CSR–corporate performance relationship, the problem is particularly severe as it is important to discern, for instance, in the case of a positive relationship, whether the move to CSR is an autonomous driver of improvement in corporate performance or, quite the opposite, high cash-flow and better-performing firms are more likely to choose CSR due to their higher cash-flow availability. A second, almost insurmountable limitation is that balance sheet analyses of the CSR–corporate performance nexus do not provide a risk-adjusted measure of performance (McWilliams & Siegel, 1997; McWilliams, Siegel, & Teoh, 1999).

Conversely, the two advantages of investigating the impact of CSR on corporate performance in financial markets are that, by calculating abnormal returns at the announcement date, i) we pick up the expected net effect of entry into/exit from CSR – hence, we separate the effect of change in CSR on corporate performance from the reverse causality effect – and ii) we may calculate its net of measurable risk factors. Of course, as it is well known, an event study analysis may present problems, such as sensitivity to waves of market optimism or pessimism and a restrictive assumption that a stock market reaction arises from rational fully informed investors making their choices on the basis of the maximization of their expected wealth. For the first point, an analysis in which events are scattered over a long span of time and a robustness check in which dummies for stock market seasonality are included in the estimate of the determinants of abnormal returns should reduce the problem. On the second point, we will see that when interpreting our findings, the case of SR investment is exactly one in which the hypothesis of investors choosing only on the basis of the maximization of their expected wealth may not apply. SR investors may in fact decide to sell a stock not because it is not going to be profitable, but because it no longer complies with CSR standards.

Finally, in our event study analysis, an observational equivalence issue related to the endogeneity problem in the relationship between CSR and corporate performance may still persist if exit from the Domini 400 coincides with a financial distress shock. In such cases,