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Corporate social responsibility can be an insurance policy against stock price decline

Review of Godfrey, P. C., C. B. Merrill and J. M. Hansen. (2009) "The relationship between corporate social responsibility and shareholder value: An empirical test of the risk management hypothesis." *Strategic Management Journal*, 30 (4): 425-445.

Review by Robert Kropp.

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Summary

While studies increasingly show companies practicing corporate social responsibility (CSR) derive financial benefits, can such activities also preserve financial performance? Godfrey, Merrill, and Hansen study a total of 254 negative legal or regulatory actions taken against 99 companies. They determine CSR activities can indeed create "value for shareholders in the face of certain types of negative events." In an important contribution, the authors distinguish between technical CSR (TCSR), aimed at primary stakeholders, and institutional CSR (ICSR), which addresses secondary stakeholders with little or no direct influence on corporate operations. Because ICSR is perceived to be voluntary it leads to lesser decreases in shareholder value in the presence of a negative event.

- Paper tests a recent theory that CSR might have an insurance-like function, as stakeholders may temper their negative judgements against responsible firms;
- Study extends theory, suggesting that stakeholders will only grant corporations an insurance-like protection for responsibility towards society as a whole, and not for responsibility towards trading partners; and
- An empirical analysis is conducted. It supports the extended theory, as corporations displaying social responsibility towards society are found to be penalised less by financial markets than their peers.

Main review

Research increasingly indicates that companies practicing corporate social responsibility (CSR) derive financial benefits from the practice. Godfrey, Merrill, and Hansen point out, however, the orientation of most research "has been to argue and show that CSR activities generate corporate financial performance (CFP)." According to the authors, improved revenue generation is shown to result from corporate activities which anticipate government regulatory action and integrate energy efficiency initiatives.

But can CSR activities preserve, as well as generate, CFP? One way to determine this, according to the authors, is to "match firm-specific characteristics to firm-specific events." This method has been used in past research which studies the pay-offs associated with CSR programmes in the wake of the 1999 WTO meetings in Seattle.¹ One way to explain pay-offs in the face of negative events is when CSR activities become public knowledge, companies can "accrue positive attributions or moral capital."

Using a sample of 160 companies listed in the Socrates dataset constructed by the KLD investment firm from 1991–2002, the authors reviewed Wall Street Journal articles published between 1992 and 2003. They found 99 companies where 254 negative legal or regulatory actions were taken. The authors then ran regressions on stock returns for the companies in the sample against returns on a broad market portfolio. The findings of the study, according to the authors, do "indicate that CSR, particularly investment aimed at secondary stakeholders, represents a potential method of creating value for shareholders in the face of certain types of negative events."

"In short," the authors continue, "participation in CSR activities does seem to yield insurance-like protection to a number of firms." These findings, however, are subject to an important distinction between two types of CSR: Technical CSR (TCSR) and institutional CSR (ICSR). TCSR refers to the claims upon companies made by primary stakeholders, who have the urgency and power to enforce claims upon companies. ICSR, on the other hand, refers to secondary stakeholders who, while having influence over primary stakeholders, lack both urgency and power to enforce those claims.

In the case of TCSR, "CSR activities targeting primary stakeholders should produce exchange capital among those groups." On the other hand, such activities "are less likely to produce moral capital." However, because ICSR activities cannot be attributed to self-interest, such activities "are more likely to be viewed as voluntary acts of social beneficence, based on normative or pragmatic appeals, and thus provide evidence of an 'other-regarding' orientation by the firm's managers."

¹ Schnietz and Epstein 'Does corporate social responsibility pay off?'

The authors find that in the presence of a negative event, shareholder value decreases less when the company involved is perceived as engaging in CSR activities. Furthermore, the authors find, the "shareholder value-loss mitigating property of CSR engagement is greater for institutional CSR activities than for technical CSR activities." This distinction, according to the authors, can be attributed to the fact that ICSR activities, while not inherently different from TCSR activities, are perceived by stakeholders to possess the aforementioned "other-regarding orientation."

The authors also find higher intangible assets within a company greatly mitigates the effects of CSR activities. Because large companies have higher public profiles than do their smaller counterparts, the mitigating effect of CSR activities is greater for them. Companies with fewer negative social impacts experience a more positive effect on shareholder value from CSR activities compared with companies with more such impacts.

In an interesting discussion of the potential limitations of their findings, the authors consider whether quality of management could present an alternative explanation for the positive relationship between CSR and CFP. After all, the authors observe, "It seems reasonable to assert that investors would always reward the quality of management." However, because the authors found that TCSR activities only benefited the larger firms in their study, while engagement in ICSR benefited large parties, the quality of management theory seems disproved. This is because a "lack of an observed relationship between CSR and CFP in (TCSR) settings casts doubt on the logical structure of the quality of management hypothesis."