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The Corporate Social Responsibility (CSR) Trend

by Barbara Lougee, University of San Diego, and James Wallace, Claremont Graduate University

What is the purpose of the corporation? There have been many different answers to this question, with great thinkers presenting theories that have taken on almost cult-like status. At one extreme are those who suggest that the only legitimate purpose of a corporation is to maximize its value to its investors. This belief is perhaps best represented by one of its earliest proponents, Milton Friedman, who in 1962 stated:

*Few trends could so thoroughly undermine the very foundation of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible.*¹

But Friedman's view, radical for its time, has by no means won universal acceptance. Dave Packard, the co-founder of the Hewlett Packard Company, suggested a different reason for why a company exists:

*I think many people assume, wrongly, that a company exists simply to make money. While this is an important result of a company's existence, we have to go deeper and find the real reason for our being. As we investigate this, we inevitably come to the conclusion that a group of people get together and exist as an institution that we call a company so that they are able to accomplish something collectively that they could not accomplish separately—they make a contribution to society, a phrase which sounds trite but is fundamental.*²

Packard's view was later broadened and given a more formal expression by Edward Freeman, who developed what has come to be known as "stakeholder" theory.³ In contrast with Friedman's shareholder value theory, which implies that the only completely reliable indicators of corporate success are increases in shareholder value, stakeholder theory maintains that corporate performance should be evaluated in terms of its ability to satisfy not only its shareholders, but also other important corporate constituencies such as customers,

employees, suppliers, local communities, and society at large.

The aims of stakeholder theory are closely aligned with a concept—or perhaps "movement" is a better word—called "Corporate Social Responsibility," now widely referred to as "CSR," which has gained considerable attention in recent years. Like stakeholder theory, CSR urges companies to identify all their important stakeholder groups and seek to "balance" the priorities and goals of each of these groups.

While Friedman's and Freeman's views represent opposite ends of a continuum, others have advocated a middle ground. Peter Drucker, in one of his early (1954) books called "The Practice of Management," defined the purpose of a business in terms of its benefits for customers:

*If we want to know what business is, we have to start with its purpose. And the purpose must lie outside the business itself. In fact, it must lie in society, since a business enterprise is an organ of society. There is only one valid definition of business purpose: to create a customer. The customer is the foundation of a business and keeps it in existence. He alone gives employment. And it is to supply the customer that society entrusts wealth-producing resources to the business enterprise.*⁴

But writing over 40 years later, Drucker produced a statement of corporate purpose that, while addressing the concerns of stakeholder theorists and CSR advocates, is strikingly similar to Milton Friedman's:

A business that does not show a profit at least equal to its cost of capital is socially irresponsible; it wastes society's resources. Economic profit performance is the base without which business cannot discharge any other responsibilities, cannot be a good employer, a good citizen, a good neighbor. But economic performance is not the only responsibility of a business... Every organization must assume responsibility for its impact on employees, the environment, customers, and whomever and whatever it touches. That is social responsibility. But we know that society

1. Milton Friedman, *Capitalism and Freedom*, Chicago: University of Chicago Press, 1962.

2. Quoted in Charles Handy, "What's A Business For?," *Harvard Business Review* (2002).

3. Edward Freeman, *Strategic Management: A Stakeholder Perspective* (Prentice-Hall Englewood Cliffs, NJ, 1984).

4. Peter Drucker, *The Practice of Management* (Harper & Row, New York, 1954).

An exchange between Milton Friedman and Whole Foods Market CEO John Mackey

Whole Foods Market Founder and CEO, John Mackey:

I believe that the enlightened corporation should try to create value for *all* of its constituencies. From an investor's perspective, the purpose of the business is to maximize profits. But that's not the purpose for other stakeholders—for customers, employees, suppliers, and the community. Each of those groups will define the purpose of the business in terms of its own needs and desires, and each perspective is valid and legitimate.

My argument should not be mistaken for a hostility to profit. I believe I know something about creating shareholder value. When I co-founded Whole Foods Market 27 years ago, we began with \$45,000 in capital; we only had \$250,000 in sales our first year. During the last 12 months we had sales of more than \$4.6 billion, net profits of more than \$160 million, and a market capitalization over \$8 billion.

But we have not achieved our tremendous increase in shareholder value by making shareholder value the primary purpose of our business...the most successful businesses put the customer first, ahead of the investors. In the profit-centered business, customer happiness is merely a means to an end: maximizing profits. In the customer-centered business, customer happiness is an end in itself, and will be pursued with greater interest, passion, and empathy than the profit-centered business is capable of.

Not that we're only concerned with customers. At Whole Foods, we measure our success by how much value we can create for all six of our most important stakeholders: customers, team members (employees), investors, vendors, communities, and the environment....

Many thinking people will readily accept my arguments that caring about customers and employees is good business. But they might draw the line at believing a company has any responsibility to its community and environment. To donate time and capital to philanthropy, they will argue, is to steal from the investors. After all, the corporation's assets legally belong to the investors, don't they? Management has a fiduciary responsibility to maximize shareholder value; therefore, any activities that don't maximize shareholder value are violations of this duty. If you feel altruism towards other

people, you should exercise that altruism with your own money, not with the assets of a corporation that doesn't belong to you.

This position sounds reasonable. A company's assets do belong to the investors, and its management does have a duty to manage those assets responsibly. In my view, the argument is not wrong so much as it is too narrow.

First, there can be little doubt that a certain amount of corporate philanthropy is simply good business and works for the long-term benefit of the investors. For example: In addition to the many thousands of small donations each Whole Foods store makes each year, we also hold five 5% Days throughout the year. On those days, we donate 5 percent of a store's total sales to a nonprofit organization. While our stores select worthwhile organizations to support, they also tend to focus on groups that have large membership lists, which are contacted and encouraged to shop our store that day to support the organization. This usually brings hundreds of new or lapsed customers into our stores, many of whom then become regular shoppers. So a 5% Day not only allows us to support worthwhile causes, but is an excellent marketing strategy that has benefited Whole Foods investors immensely.

That said, I believe such programs would be completely justifiable even if they produced no profits and no P.R. This is because I believe the entrepreneurs, not the current investors in a company's stock, have the right and responsibility to define the purpose of the company. It is the entrepreneurs who create a company, who bring all the factors of production together and coordinate it into viable business. It is the entrepreneurs who set the company strategy and who negotiate the terms of trade with all of the voluntarily cooperating stakeholders—including the investors.

Another objection to the Whole Foods philosophy is where to draw the line. If donating 5 percent of profits is good, wouldn't 10 percent be even better? Why not donate 100 percent of our profits to the betterment of society? But the fact that Whole Foods has responsibilities to our community doesn't mean that we don't have any responsibilities to our investors. It's a question of finding the appropriate balance and trying to create value for all of our stakeholders.

Milton Friedman

The differences between John Mackey and me regarding the social responsibility of business are for the most part rhetorical. Strip off the camouflage, and it turns out we are in essential agreement. Moreover, his company, Whole Foods Market, behaves in accordance with the principles I spelled out in my 1970 *New York Times Magazine* article.

With respect to his company, it could hardly be otherwise. It has done well in a highly competitive industry. Had it devoted any significant fraction of its resources to exercising a social responsibility unrelated to the bottom line, it would be out of business by now or would have been taken over.

Here is how Mackey himself describes his firm's activities:

1) "The most successful businesses put the customer first, instead of the investors" (which clearly means that this is the way to put the investors first).

2) "There can be little doubt that a certain amount of corporate philanthropy is simply good business and works for the long-term benefit of the investors."

Compare this to what I wrote in 1970:

"Of course, in practice the doctrine of social responsibility is frequently a cloak for actions that are justified on other grounds rather than a reason for those actions.

"To illustrate, it may well be in the long run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government....

"In each of these...cases, there is a strong temptation to rationalize these actions as an exercise of 'social responsibility.' In the present climate of opinion, with its widespread aversion to 'capitalism,' 'profits,' the 'soulless corporation' and so on, this is one way for a corporation to generate goodwill as a by-product of expenditures that are entirely justified in its own self-interest.

"It would be inconsistent of me to call on corporate executives to refrain from this hypocritical window-dressing because it harms the foundations of a free society. That would be to call on them to exercise a 'social responsibility'! If our institutions and the attitudes of the public make it in their self-interest to cloak their actions in this way, I cannot summon much indignation to denounce them."

Finally, I shall try to explain why my statement that "the social responsibility of business [is] to increase its profits" and Mackey's statement that "the enlightened corporation should try to create value for all of its constituencies" are equivalent.

Note first that I refer to *social* responsibility, not financial, or accounting, or legal. It is social precisely to allow for the constituencies to which Mackey refers. Maximizing profits is an end from the private point of view; it is a means from the social point of view. A system based on private property and free markets is a sophisticated means of enabling people to cooperate in their economic activities without compulsion; it enables separated knowledge to assure that each resource is used for its most valued use, and is combined with other resources in the most efficient way.

will increasingly look to major organizations, for-profit and nonprofit alike, to tackle major social ills. And that is where we had better be watchful, because good intentions are not always socially responsible. It is irresponsible for an organization to accept—let alone pursue—responsibilities that would impede its capacity to perform its main task and mission or to act where it has no competence.⁵

And eight years later, in a book called “*A Functioning Society*,” Drucker provided a more formal definition of the corporation’s overriding objective:

*We no longer need to theorize about how to define performance and results in the large enterprise. We have successful examples. ... [T]hey do not “balance” anything. They maximize. But they do not attempt to maximize shareholder value or the short-term interest of any one of the enterprise’s “stakeholders.” Rather, they maximize the wealth-producing capacity of the enterprise. It is this objective that integrates short-term and long-term results and that ties the operational dimensions of business performance—market standing, innovation, productivity, and people and their development—with the financial needs and financial results. It is also this objective on which all the constituencies—whether shareholders, customers, or employees—depend for the satisfaction of their expectations and objectives.*⁶

This statement of the corporate mission is remarkably similar to a concept that was formulated several years earlier by Michael Jensen and given the name “enlightened value maximization.” In an article published in this journal in 2001,⁷ Jensen began by observing that 200 years of work in economics and finance have demonstrated that, in the absence of “externalities” and monopoly, social welfare is maximized when each firm aims to maximize its own market value. But, as Jensen went on to say, while value maximization should be the corporation’s “objective function,” it does not provide management with a strategy on how to maximize value. “Can corporate managers succeed,” Jensen asks,

...by simply holding up value maximization as the goal and ignoring their stakeholders? The answer is an emphatic no. In order to maximize value, corporate managers must not only satisfy, but enlist the support of, all corporate stakeholders—customers, employees, managers, suppliers, local communities.

Accordingly, Jensen’s concept of enlightened value maximization uses “much of the insight and structure of stakeholder theory but accepts maximization of the long run value of the firm as the criterion for making the requisite trade-offs among

its stakeholders.”

The main problem with stakeholder theory, then, as Jensen suggests, is its failure to give managers a means of balancing the conflicting demands of the corporation’s various stakeholders. Customers want high quality goods and great services at low prices; employees want high compensation and a stress-free work environment; communities want large donations to local projects; the government wants higher tax receipts, and so on. In a world of scarce resources and ever rising demands, stakeholder theory and CSR leave managers without the criteria necessary to make the trade-offs that are critical to—and in fact the essence of—effective management. By contrast, value maximization, particularly in its enlightened form, provides managers with a clear rule: Keep investing another dollar in each stakeholder as long as the present value of the expected benefits from that investment continues to equal at least a dollar.

Two Conceptions of CSR: “Moral” and “Economic.” As Jensen’s argument suggests, there are thus two fundamentally different motives for companies to “invest” in CSR initiatives. In a 2002 *Harvard Business Review* article called “What’s A Business For?,” Charles Handy made what might be called the “moral” case for CSR:

*The purpose of a business. ...is not to make a profit, full stop. It is to make a profit so that the business can do something more or better. That “something” becomes the real justification for the business... It is a moral issue. To mistake the means for the end is to be turned in on oneself, which Saint Augustine called one of the greatest sins... It is salutary to ask about any organization, “If it did not exist, would we invent it?” “Only if it could do something better or more useful than anyone else” would have to be the answer, and profit would be the means to that larger end.*⁸

In Handy’s view, and that of many CSR proponents, corporations have obligations to their customers, employees, and communities that should not be subordinated to, but *given at least equal priority* with, their economic mission of creating profits for their shareholders.

By contrast, the economic argument for CSR views it as a positive-NPV investment—one intended to increase what Drucker calls the long-run “wealth-creating capacity of the enterprise.” In other words, it simply makes good business sense to have a program of CSR; it is an essential component of the “political economy” of running a large organization in a world where public opinion and politicians can have major effects on corporate values.

Some proponents of CSR go so far as to view it as a critical point of firm differentiation and source of competi-

5. Peter Drucker, *Managing in a Time of Great Change* (Truman Talley/E.P. Dutton, 1995).

6. Peter Drucker, *A Functioning Society* (Transaction Publishers, 2003).

7. Michael Jensen, “Value Maximization, Stakeholder Theory, and the Corporate Objective Function,” *Journal of Applied Corporate Finance*, Vol. 14 No. 3 (Fall 2001).

8. C. Handy, “What’s a Business For?,” *Harvard Business Review* (December, 2002), p. 54.

tive advantage. The following are often cited as significant benefits of CSR programs:

Employee Recruiting and Retention. It is increasingly common for recruits to inquire about CSR policy. Strong CSR policy can be used to recruit and retain employees, and to help create or maintain an atmosphere of pride within the organization.

Risk Management. Scandals and accidents can, almost overnight, destroy reputations that often require decades to build up. These events often draw negative publicity and attention from regulators and the courts. A strong CSR program can help prevent such episodes from occurring or can work to limit damages in the event they occur. For companies with existing reputational problems in their core businesses, engaging in high-profile CSR activities may divert attention from these problems. Examples include British American Tobacco's health initiatives, British Petroleum's installation of alternate energy wind turbines, and Wal-Mart's decisions to sell organic groceries and build eco-friendly stores.

Brand Differentiation. Companies can use CSR to differentiate themselves from competitors with aim of increasing sales and market share. Whole Foods Markets, Ben & Jerry's, and The Body Shop have all successfully used CSR as a brand differentiator.

Avoidance of Government Interference. Organizations that make efforts to be good citizens may be more successful at avoiding excessive regulatory intervention. For example, when attempting to enter new markets, companies such as Target and Costco, with their superior CSR reputations, rarely face the same level of resistance as Wal-Mart, with its poor CSR reputation. C.W. Goodyear, the CEO of BHP Billiton, a leading natural resources company, made this point as follows:

BHP Billiton realized a long time ago that working in partnership with communities is more than about being a good corporate citizen. It's a powerful competitive differentiator. It has the potential to establish us as the company of choice, giving us better access to markets, natural resources, and the best and brightest employees. By doing so, we can maximize profits for our shareholders (keeping the Friedman adherents happy) while also ensuring we do the right thing by those who are impacted by our business.⁹

In 2003 a major controversy erupted over the decision by the Augusta National Golf Club, home of the U.S. Masters golf tournament, not to open the club to women members. The National Council of Women's Organizations followed

with a campaign aimed at the golf tournament's sponsors. The club's management refused to modify its stance, leading to even more negative publicity. Things went from bad to worse when the Ku Klux Klan announced it would attend the tournament in a show of support to the Club's right to exclude women. A public relations nightmare resulted from the Club's refusal to adopt a more enlightened stance before events got carried away.

In contrast, Bank of America, in its 2003 sponsorship of the PGA Tour event, The Colonial, invited Annika Sorenstam, the top woman player, to compete. This invitation raised the general interest in the tournament, and provided Bank of America with wide praise and positive press coverage for its progressive attitude.

Bank of America is hardly alone in realizing the positive effects of a positive CSR program. NIKE learned from its past miscues and established a Vice President for Corporate Responsibility and now publishes an annual CSR report. In so doing, the company has established itself as a committed corporate citizen and no longer faces near the level of negative publicity and consumer boycotts it faced a decade earlier.

Evidence of Success

But apart from stories like those of NIKE and Bank of America, what evidence do we have about the effects of such programs on long-run corporate financial performance and shareholder returns? Many academic studies have examined the link between CSR and corporate performance using different sets of companies, time periods, and statistical methods. But the findings have been far from consistent. Nevertheless, one fairly recent overview of 52 individual studies¹⁰ reported finding support for three main conclusions. First, CSR programs and activities are generally associated with higher or improved financial performance across a variety of industries and time periods. Second, the evidence on balance suggests a two-way chain of causality between CSR and financial performance, a "virtuous" cycle in which financially successful companies spend more on CSR outlays in part because they can afford to, but also find that their CSR programs contribute to even greater success. And third and last, the effects of CSR on financial performance appear to come mainly from its effects on the firm's reputation with external stakeholders and not from internal improvements in efficiency.¹¹

In the remainder of this article, we describe and present the findings of our own recent research that aims to answer three related questions about CSR:

(1) Are corporations increasing their embrace of what is

9. Goodyear, C., "Social Responsibility Has a Dollar Value," Theage.com, July 27, 2006.

10. Orlitzky, M., Schmidt, F., and Rynes, S. "Corporate Social and Financial Performance: A Meta-Analysis," *Organization Studies*, Vol. 24, No. 3 (2003), p. 403.

11. Researchers measured the firm's reputation with external stakeholders using different "reputational indices." For example: (1) Moskowitz's (1972, 1975) tripartite rat-

ings ('outstanding', 'honourable mention', and 'worst' companies); (2) *Fortune* magazine ratings of a corporation's 'responsibility to the community and environment'; (3) other researchers constructed their own reputational indices by surveying business professionals and business students. Using reputational indices relies on the assumption that a firm's CSR reputation provides a meaningful measure of its underlying CSR values and behaviors.

The Case of Nike

To illustrate how KLD assigns CSR strengths and concerns, consider NIKE, Inc., which placed 13th in our rankings. In total, NIKE had 12 CSR strengths and five CSR concerns from the seven general categories listed above. NIKE scored very well within the community category with three noted strengths and no concerns. NIKE's partnerships with community organizations to support increased physical activity among children are an example of a CSR strength. In fiscal year 2005, the company contributed over \$15 million to these programs. KLD therefore assigned NIKE a strength in the innovative giving category. NIKE also has a strength in the area of Human Rights for labor rights. In

2005 NIKE shifted from using outside compliance monitors for its supplier factories, to using an internal team. The Fair Labor Association, a non-profit monitoring group, voted to accredit NIKE's compliance programs, stating that NIKE was found to be in "substantial compliance" with the Fair Labor Association requirements.

NIKE's human rights record is not without concerns, however. For example, Labour Behind the Label, a network of labor rights groups in the United Kingdom, found that half of the factories that produce goods for NIKE paid workers below the legal minimum wage. KLD therefore also assigned NIKE a concern in the area of labor rights.

considered socially responsible behavior?

(2) How does corporate investment in social responsibility affect the firm's financial performance and shareholder value?

(3) Why do companies choose to invest in CSR, as a means of maximizing value or to "do the right thing" as an end in itself?

Our Study

We attempted to answer these three questions by examining trends in CSR over the past 15 years for two samples of companies, the S&P 500 and Domini 400, an index of 400 companies that was developed in 1990 specifically for socially conscious investors.¹² In conducting our study, we used a KLD Research & Analytics database that, for each of these companies, contains quantitative measures of over 90 social and environmental indicators that are grouped into seven broad categories: Community, Corporate Governance, Diversity, Employees, Environment, Human Rights, and Products. (Each of these seven categories corresponds to one of six major stakeholder groups, with Community, Employees, and Environment each representing one of the six groups, Products corresponding to customers, Corporate Governance to shareholders, and Diversity and Human Rights to employees and "society.") Within each of the seven categories, KLD defines a set of potential strengths (for example, "charitable giving" is grouped under "Community") and a set of potential

concerns (e.g., "hazardous waste" under "Environment"). For each company, KLD assigns a value of "1" if the strength or concern exists and a "0" otherwise.¹³ Exhibit 1 displays the seven KLD CSR categories, along with the strengths and concerns associated with each category.

Appendix A provides a list of the 100 top-ranked CSR companies based on 2006 KLD data. We ranked the companies using a measure of overall CSR that is computed using standardized differences from the mean sample values. The appendix also includes a detailed description of this procedure.

Question 1: Is There a Trend in CSR? Using a social responsibility metric that measures the net strengths (that is, number of strengths minus number of concerns) for each company, we found that the average (net) CSR decreased during our 15-year time period (see Exhibit 2).¹⁴ As expected, despite overall declines in both samples, net CSR strength remained higher in Domini 400 firms than in S&P 500 firms in every year. The declines were generally consistent among the various stakeholder groups. Interestingly, we also found that companies have increased their strengths during this 15-year period. However, the increase in the number of strengths was more than countered by the increase in concerns.¹⁵

We present two company profiles in Exhibit 3 to illustrate this phenomenon. Both Xerox, the fifth company in our rankings of the top 100 CSR companies, and Agilent Technologies, the top overall company, showed increases in

12. Because the KLD database originally included only firms in the S&P 500 or Domini 400, our sample includes only these firms. The KLD database recently expanded its coverage, by adding firms in the Russell 3000.

13. Over 40 studies published in peer-reviewed journals use the KLD database.

14. In arriving at the numbers shown in Exhibit 2, we created new variables from the KLD database in order to provide a consistent measure over our entire 15-year time period. KLD has slightly altered the strength and concern items they include in each category from year-to-year, with some years including different numbers of strength items relative to concern items. Our adjusted variables provide a consistent set of items, with equal numbers of strengths and concerns criteria.

15. We cannot eliminate the possibility that the observed decrease in net CSR over time is due to a shift in expectations which occurred over time. For example, environmental standards are much higher today than in the past. Further, although our CSR data are widely used in academic research and were produced by a well-respected and independent body, the data are based on judgment. KLD has a set of criteria for rating firms, but the decision to assign a CSR strength or concern is based on human judgment. In addition, the criteria are not static. For example, in the past, firms that traded with South Africa were assigned a CSR "concern." With the end of apartheid this concern was removed, and new items have replaced it.

Exhibit 1 **KLD Research & Analytics, Inc. Ratings Criteria**

Strengths

Community

- Charitable Giving
- Innovative Giving
- Non-US Charitable Giving
- Support for Education
- Support for Housing
- Volunteer Programs
- Other Strengths

Corporate Governance

- Compensation
- Ownership
- Political Accountability
- Transparency
- Other Strengths

Diversity

- Board of Directors
- CEO
- Employment of the Disabled
- Promotion
- Women & Minority Contracting
- Work/Life Benefits
- Gay & Lesbian Policies
- Other Strengths

Employee Relations

- Health and Safety
- Retirement Benefits
- Union Relations
- Cash Profit Sharing
- Employee Involvement
- Other Strengths

Environment

- Beneficial Products & Services
- Clean Energy
- Pollution Prevention
- Recycling
- Other Strengths

Human Rights

- Labor Rights
- Relations with Indigenous Peoples
- Other Strengths

Product

- Benefits the Economically Disadvantaged
- Quality
- R&D/Innovation
- Other Strengths

Concerns

- Investment Controversies
- Negative Economic Impact
- Tax Disputes
- Other Concerns

- Compensation
- Ownership
- Political Accountability
- Transparency
- Accounting
- Other Concerns

- Controversies
- Non-Representation
- Other Concerns

- Union Relations
- Health and Safety
- Retirement Benefits
- Workforce Reductions
- Other Concerns

- Agricultural Chemicals
- Climate Change
- Hazardous Waste
- Ozone Depleting Chemicals
- Regulatory Problems
- Substantial Emissions
- Other Concerns

- Labor Rights
- Relations with Indigenous Peoples
- Myanmar
- Other Concerns

- Antitrust
- Marketing/Contracting Controversy
- Safety
- Other Concerns

Exhibit 2 Trends in CSR

Year	All Firms			DS400			SP500		
	Strengths	Concerns	Net	Strengths	Concerns	Net	Strengths	Concerns	Net
1991	1.11	0.79	0.32	1.30	0.32	0.98	1.06	0.97	0.08
1992	1.34	1.13	0.21	1.58	0.57	1.01	1.27	1.38	-0.11
1993	1.46	1.45	0.01	1.67	0.85	0.82	1.40	1.70	-0.30
1994	1.63	1.72	-0.09	1.85	1.10	0.75	1.59	1.98	-0.39
1995	1.76	1.72	0.04	1.99	1.18	0.82	1.69	1.95	-0.26
1996	1.67	1.29	0.38	1.87	0.88	0.99	1.63	1.45	0.18
1997	1.79	1.66	0.13	2.01	1.18	0.83	1.74	1.90	-0.15
1998	1.83	1.74	0.09	2.04	1.21	0.84	1.81	2.02	-0.21
1999	1.84	1.79	0.05	2.08	1.18	0.90	1.81	2.10	-0.30
2000	1.83	1.82	0.01	2.03	1.24	0.80	1.84	2.14	-0.30
2001	1.87	2.09	-0.22	2.06	1.45	0.61	1.87	2.47	-0.60
2002	1.90	2.19	-0.29	2.12	1.52	0.60	1.91	2.60	-0.69
2003	1.75	2.53	-0.77	1.97	1.89	0.08	1.77	2.96	-1.18
2004	1.72	2.59	-0.87	1.95	1.94	0.01	1.74	3.06	-1.33
2005	1.85	2.77	-0.91	1.97	2.08	-0.12	1.92	3.17	-1.25

Exhibit 3 An Illustration of CSR Net Scores

Company	Year	Number of Strengths	Number of Concerns	Net CSR Score
Xerox Corporation	2000	11	2	9
	2005	14	7	7
Agilent Technologies	2000	1	1	0
	2005	13	4	9

the number of CSR strengths from the year 2000 to the year 2005. In the case of Xerox, even with an increase in CSR strengths, its net score declined due to the increase in the number of CSR concerns over the same period. Agilent Technologies, in contrast, was able to improve its net score even though it also reported an increase in the number of CSR concerns over this period.

Question 2: Is CSR Associated with Good Performance? As noted above, the academic literature has found some support for the premise that CSR makes financial sense. Most of these studies have compared the performance of portfolios of firms with high CSR to benchmark portfolios such as the S&P 500. We provide similar evidence in Figure 1, which shows that the Domini 400 has outperformed the benchmark S&P 500 firms over the entire period, since its inception in April

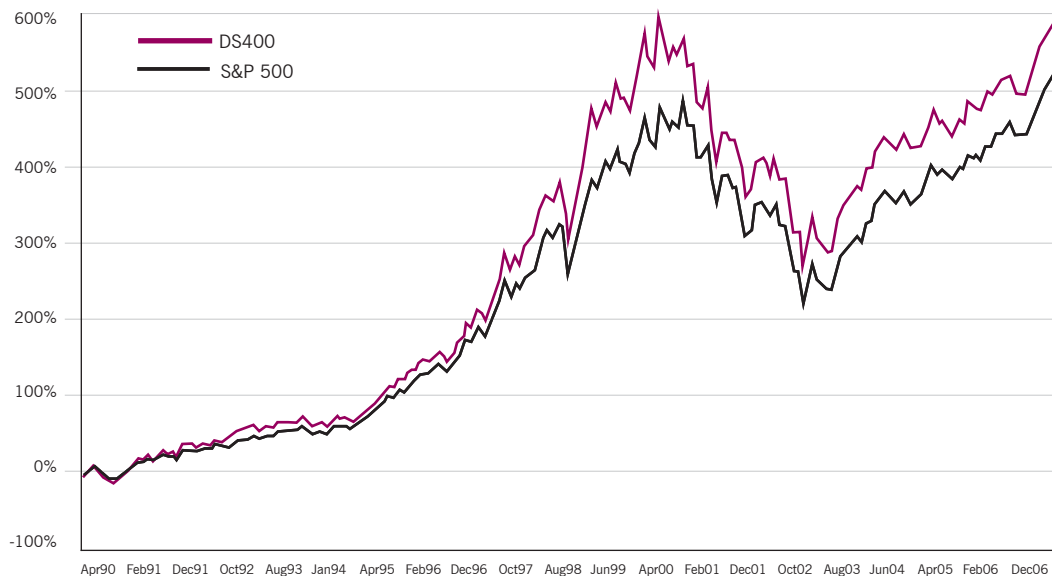
1990 through December 2006. Throughout this period, the Domini 400 has delivered an annual rate of 12.09% while the benchmark, S&P 500, has produced an annual rate of 11.45%.

After confirming previous findings that one does not sacrifice earning superior returns by investing in a portfolio of stocks of socially responsible firms, we next attempted to examine whether CSR programs are associated with better corporate performance and higher returns to shareholders. To answer this question, we used regression analysis to examine the association of both a company's total CSR strengths and its total CSR concerns with its financial performance, as measured by return on assets (ROA).¹⁶ To control for possible size effects in the regression, we also included a variable for firm sales.

16. As described in Appendix A, the KLD data include seven categories of CSR strengths and seven categories of CSR concerns for each firm: community, corporate governance, employees, environment, diversity, human rights, and products. For each strength category (or concern category), the firm is assigned a value of one if the category

pertains to the firm. For each firm, "Strengths" represent total CSR strengths, which equal the sum of strength points (or alternatively, the number of strength categories that pertain to the firm). "Concerns" represent total CSR concerns, which equal the sum of concern points.

Figure 1 Domini 400 Social Index Cumulative Performance



As summarized in Exhibit 4, our findings showed that higher ROA was associated with both more CSR strengths and fewer CSR weaknesses. This relationship was observed for both the Domini 400 and the S&P 500 firms. Moreover, this relationship also proved to be consistent among different categories of CSR strengths and concerns.

At the same time, however, the negative association between financial performance and CSR concerns was notably stronger than its positive association with CSR strengths. That is, the regression coefficients (of 0.14 in both samples) for CSR strengths and (-0.58 for Domini 400 and -0.56 for S&P 500) for CSR concerns suggest that, other things equal, reducing CSR weaknesses by 1.0 was associated with a larger increase in ROA than increasing CSR strengths by the same amount. We will return to this point in the context of our third research question.

Question 3: Why Do Companies Invest in CSR? As stated earlier, there are two main justifications for CSR programs. The “moral” argument for CSR effectively views corporations as if they were individuals, exhorting them to be “good corporate citizens” by sacrificing investor profits when necessary to honor equal if not more important commitments to other stakeholders, including society at large.

The economic argument for CSR, in contrast, views the corporation not as an individual, but (in Jensen’s famous phrase) as a “nexus of contracts” among a variety of stakeholders—some individual, some institutions—with shareholders as the “residual claimants.” (That is, the shareholders get only what’s left over after the claims, contractual or otherwise,

of all others are satisfied—and that’s why corporate managers are instructed, both by law and as a matter of economic theory, to maximize the long-run value of their claims.) Taking the point of view of the (long-term) shareholder, the economic argument views CSR as fundamentally the same as any corporate investment decision: Invest in all important corporate stakeholders—employees, customers, communities, the environment—to the point where the expected returns, at the margin, are at least equal to the cost of capital.

While the first two questions about CSR trends and the association between CSR and firm performance can be analyzed more or less directly from the existing data, there is no direct and reliable way of assessing corporate investment motives. We finesse this problem by making an inference about how “value-maximizing” CSR programs might be expected to differ from “moral”—i.e., investor-sacrificing—programs. And then we look at what the data tell us.

We begin our test with the assumption—admittedly a somewhat questionable one—that companies that are more willing to sacrifice shareholder returns for stakeholders would also be more likely to make investments *both* in increasing their CSR strengths and in decreasing their CSR concerns. In other words, if we imagine corporations as individuals taking the Hippocratic Oath as their guide, those companies adopting the moral view of CSR would begin with the admonishment, “First, do no harm.” And we would thus expect to see such companies making efforts both to increase their CSR strengths and reduce their CSR concerns. Such behavior would show up as a *negative correlation* between

Exhibit 4 Firm Performance and CSR (Within Firm)

$$\text{Model: ROA} = \beta_0 + \beta_1 \text{ Sales} + \beta_2 \text{ Strengths} + \beta_3 \text{ Concerns} + \varepsilon$$

Panel A: Results for S&P 500 Sample

Variable	Coefficient	t-statistic	p value
Intercept	5.50852	21.86	0.000
Sales	0.00003	3.08	0.002
Strengths	0.14143	2.11	0.035
Concerns	-0.55661	-7.17	0.000

Number of observations = 5474; F-statistic = 17.82; p-value = 0.0000; adjusted R-squared = 0.0091.

Panel B: Results for Domini 400 Sample

Variable	Coefficient	t-statistic	p value
Intercept	5.85300	28.72	0.000
Sales	0.00002	1.58	0.115
Strengths	0.14097	2.37	0.018
Concerns	-0.57952	-6.29	0.000

Number of observations = 4280; F-statistic = 14.08; p-value = 0.0000; adjusted R-squared = 0.0091.

these two sets of attributes, in which companies with more strengths also consistently report fewer concerns.

In contrast, companies that approach CSR from an economic position should be concerned about getting the biggest “bang for the buck” with their CSR investment. And this suggests placing a priority on building CSR strengths—perhaps to make a public demonstration of one’s progress—while subordinating efforts to address weaknesses or concerns. Since it is likely to be very costly to eliminate many CSR concerns,¹⁷ value maximizers (or at least short-term value maximizers) may find it cost-effective, or at least expedient, to build their strengths enough so as to counter any concerns. This might be thought of as a “risk management” approach to CSR. And to the extent that companies adopt such an approach, we would expect to find a *positive* correlation between these two sets of attributes—that is, companies with more strengths also reporting more concerns.

To help us decide between these two explanations for CSR programs, we ran what are known as “canonical” correlations between a firm’s seven categories of CSR strengths and its seven categories of CSR concerns. Whereas simple pairwise correlations compute the associations between pairs of variables, canonical correlations compute associations between *groups* of variables. We find a significant positive correlation (at less than the 1 percent level) between the group of seven categories

of strengths and the group of seven categories of concerns for both the S & P 500 firms and the Domini 400 firms. The correlations were similar for the two groups of firms, with the S & P 500 firms reporting a correlation of 0.39 and the Domini 400 firms reporting a correlation of 0.46.

These results are consistent with the hypothesis that corporations spend resources on CSR initiatives primarily to maximize value rather than upholding stakeholder commitments as an end in itself. We base this inference on the observed significant positive correlation, within individual companies, between the number of CSR strengths and the number of CSR concerns in each category and in both samples. In other words, companies appear to be devoting more resources to strengthen CSR attributes than to eliminate CSR concerns. And such behavior, as suggested earlier, is consistent with a strategy of using CSR as a form of risk management in which companies promote their strengths in order to divert attention from their weaknesses.

Conclusion

The study described in these pages supplements the growing body of research that attempts to improve our economic understanding of CSR. Comparing a sample of socially responsible firms (Domini 400) to a benchmark sample (S&P 500), we examined the trends in CSR and the relationship

17. On the other hand, such actions may well have a very large payoff. Witness the significantly positive market response (on the order of 10%) to GM’s recent decision to fund (while also capping) its post-retirement healthcare benefits.

between CSR and firm performance over a 15-year period from 1992-2006.

Although anecdotal evidence suggests that CSR is rapidly becoming commonplace within U.S. corporations, our findings have a somewhat mixed message. Although U.S. companies have significantly increased their CSR strengths during the past 15 years, CSR concerns appear to have proliferated during the same period, and many remain unaddressed. The net result is that our measure of *net* CSR strengths (strengths minus concerns) decreased during this period, even among the Domini 400 sample.

Second, we examined the relationship between corporate investment in CSR and financial performance over the same 15-year period. Our findings showed that companies with more CSR strengths or fewer CSR weaknesses produced higher ROA—a result that suggests that investments in CSR are consistent with profit and long-term value maximization. Also notable was the stronger association between CSR weaknesses and lower ROA, which contains two suggestions: either poorly performing companies can't afford to devote resources to CSR, or they are neglecting an opportunity to improve their performance by failing to invest in CSR.

Finally, we provide evidence intended to answer the question of why companies choose to invest in CSR. Our findings suggest that most companies devote resources to CSR initiatives as a means of maximizing long-run value rather than out of a prior commitment to stakeholders. We base this conclusion on our finding that companies appear to be investing more heavily to build their CSR strengths than to eliminate their CSR concerns. This behavior is consistent with a strategy of using CSR as a form of risk management

that promotes the firm's strengths in order to mitigate potential effects of weaknesses.

To the extent our inference is correct, it raises the question of whether this strategy is in fact consistent with Jensen's concept of "enlightened," long-run value maximization. On the one hand, it is possible—and perhaps plausible—that choosing to invest in CSR strengths to offset the damage from increased CSR concerns is simply the result of implementing a strategy of short-term profit maximization; in the short-run, it may be less costly to increase CSR strengths than reduce CSR weaknesses. But the stronger association between CSR weaknesses and lower ROA, as suggested above, might mean that companies are passing up opportunities to increase their long-run value by addressing their CSR weaknesses. On the other hand, we cannot rule out the possibility that companies may feel they have more control over their CSR strengths; and that by choosing to concentrate their investment of scarce resources in their strengths, they can offset the damage from increases in CSR concerns. To the extent that explanation is correct, such "prioritizing" of the firm's constituencies could well be consistent with long-run value maximization.

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Appendix A Ranking of the Top 100 Firms Based on 2006 KLD Data

Rank	Company Name	Community	Governance	Diversity	Human Rights	Employees	Environment	Products	Total
1	Agilent Technologies, Inc.	3.91	1.53	2.26	0.18	0.35	6.52	3.73	18.50
2	Motorola, Inc.	-0.07	0.30	3.06	4.77	2.81	4.93	2.02	17.83
3	Green Mountain Coffee Roasters, Inc.	5.90	2.76	2.26	0.18	2.81	3.33	0.31	17.56
4	Hewlett-Packard Company	7.89	-0.92	4.67	-4.41	5.27	3.33	0.31	16.14
5	Xerox Corporation	1.92	1.53	4.67	0.18	-2.11	6.52	2.02	14.74
6	Intel Corporation	3.91	0.30	3.06	0.18	5.27	3.33	-1.41	14.66
7	Starbucks Corporation	5.90	0.30	2.26	0.18	1.58	3.33	0.31	13.87
8	General Mills Incorporated	3.91	-2.15	3.06	0.18	2.81	3.33	2.02	13.17
9	Steelcase, Inc.	3.91	0.30	-0.14	0.18	0.35	6.52	2.02	13.15
10	Applied Materials, Inc.	1.92	-0.92	2.26	0.18	4.04	4.93	0.31	12.72
11	Advanced Micro Devices, Inc.	1.92	0.30	2.26	0.18	2.81	4.93	0.31	12.71
12	International Business Machines Corp.	5.90	-2.15	4.67	-4.41	2.81	3.33	2.02	12.17
13	NIKE, Inc.	5.90	1.53	0.66	0.18	0.35	4.93	-1.41	12.15
14	Texas Instruments Incorporated	1.92	0.30	3.06	0.18	4.04	1.74	0.31	11.55
15	Timberland Company (The)	3.91	1.53	2.26	0.18	1.58	1.74	0.31	11.51
16	Herman Miller, Inc.	-0.07	-0.92	3.06	0.18	1.58	4.93	2.02	10.78
17	Fannie Mae	3.91	-2.15	3.06	4.77	0.35	0.14	0.31	10.40
18	3M Company	1.92	0.30	2.26	0.18	1.58	1.74	2.02	10.01
19	Salesforce.com, Inc.	3.91	0.30	1.46	0.18	1.58	0.14	2.02	9.60
20	Ecolab Inc.	1.92	0.30	1.46	0.18	0.35	3.33	2.02	9.57
21	Avon Products, Inc.	3.91	0.30	3.87	0.18	-0.88	1.74	0.31	9.43
22	Freddie Mac	3.91	-0.92	2.26	0.18	1.58	0.14	2.02	9.17
23	Johnson & Johnson	1.92	0.30	3.06	0.18	1.58	1.74	0.31	9.09
24	American Express Company	3.91	-0.92	3.87	0.18	1.58	0.14	0.31	9.06
25	Wells Fargo & Company	3.91	-0.92	3.87	4.77	0.35	0.14	-3.12	9.00
26	Kimberly-Clark Corporation	1.92	0.30	2.26	0.18	0.35	1.74	2.02	8.78
27	Wainwright Bank & Trust Company	3.91	1.53	2.26	0.18	0.35	0.14	0.31	8.69
28	Wild Oats Markets, Inc.	3.91	0.30	0.66	0.18	1.58	1.74	0.31	8.68
29	Southwest Airlines Co.	-0.07	1.53	0.66	0.18	4.04	0.14	2.02	8.50
30	Xilinx, Inc.	-0.07	-0.92	1.46	0.18	4.04	1.74	2.02	8.45
31	Adobe Systems Incorporated	3.91	-0.92	0.66	0.18	4.04	0.14	0.31	8.32
32	Cisco Systems, Inc.	1.92	-0.92	2.26	0.18	2.81	1.74	0.31	8.29
33	SLM Corporation	3.91	-0.92	3.06	0.18	1.58	0.14	0.31	8.26
34	Temple-Inland Inc.	3.91	0.30	0.66	0.18	-0.88	1.74	2.02	7.93
35	Baxter International Inc.	3.91	0.30	2.26	0.18	-0.88	4.93	-3.12	7.59
36	Advent Software, Inc.	1.92	-0.92	3.06	0.18	2.81	0.14	0.31	7.50
37	Heartland Financial USA, Inc.	5.90	1.53	-0.95	0.18	0.35	0.14	0.31	7.47
38	Interface, Inc.	-0.07	1.53	-0.14	0.18	0.35	4.93	0.31	7.09
39	Chittenden Corporation	3.91	1.53	0.66	0.18	0.35	0.14	0.31	7.08
40	Abington Community Bancorp	1.92	1.53	-0.14	0.18	2.81	0.14	0.31	6.75
41	Eastman Kodak Company	-0.07	0.30	3.06	0.18	2.81	0.14	0.31	6.74
42	TradeStation Group, Inc.	-0.07	1.53	3.06	0.18	1.58	0.14	0.31	6.74
43	Louisiana-Pacific Corporation	-0.07	1.53	-0.14	0.18	1.58	3.33	0.31	6.72
44	Trex Company, Inc.	-0.07	1.53	-0.14	0.18	1.58	3.33	0.31	6.72
45	eBay, Inc.	1.92	-0.92	2.26	0.18	2.81	0.14	0.31	6.70
46	Bank of Hawaii Corporation	1.92	0.30	2.26	0.18	1.58	0.14	0.31	6.70
47	Cummins, Inc.	1.92	1.53	2.26	0.18	0.35	0.14	0.31	6.69
48	LSI Logic Corporation	-0.07	-0.92	2.26	0.18	1.58	3.33	0.31	6.67
49	Sovereign Bancorp, Inc.	3.91	0.30	1.46	0.18	0.35	0.14	0.31	6.66
50	Whole Foods Market, Inc.	1.92	-0.92	1.46	0.18	0.35	3.33	0.31	6.63
51	Bristol-Myers Squibb Company	7.89	-2.15	3.06	0.18	-0.88	3.33	-4.83	6.61
52	Pitney Bowes, Inc.	-0.07	0.30	3.87	0.18	0.35	3.33	-1.41	6.56
53	Graco Inc.	1.92	0.30	-0.14	0.18	0.35	0.14	3.73	6.49
54	Lam Research Corporation	-0.07	-0.92	0.66	0.18	2.81	1.74	2.02	6.41
55	First Horizon National Corporation	1.92	0.30	0.66	0.18	2.81	0.14	0.31	6.32

56	First Financial Holdings, Inc.	1.92	1.53	0.66	0.18	1.58	0.14	0.31	6.32
57	Network Appliance, Inc.	-0.07	-0.92	2.26	0.18	2.81	1.74	0.31	6.30
58	WGL Holdings, Inc.	-0.07	0.30	2.26	0.18	1.58	1.74	0.31	6.30
59	MBIA Inc.	1.92	-0.92	3.06	0.18	1.58	0.14	0.31	6.27
60	Phoenix Companies, Inc. (The)	1.92	0.30	3.06	0.18	0.35	0.14	0.31	6.27
61	ITT Corporation	-0.07	1.53	2.26	0.18	0.35	3.33	-1.41	6.18
62	Washington Mutual, Inc.	5.90	-0.92	3.06	0.18	-0.88	0.14	-1.41	6.08
63	Nucor Corporation	-2.06	0.30	-0.14	0.18	4.04	1.74	2.02	6.08
64	Coherent, Inc.	-0.07	-0.92	1.46	0.18	1.58	1.74	2.02	5.99
65	Popular, Inc.	-0.07	0.30	2.26	0.18	2.81	0.14	0.31	5.94
66	Forest Laboratories, Inc.	-0.07	0.30	2.26	0.18	2.81	0.14	0.31	5.94
67	Baldor Electric Company	-0.07	0.30	0.66	0.18	2.81	1.74	0.31	5.93
68	Medifast, Inc.	1.92	1.53	1.46	0.18	0.35	0.14	0.31	5.89
69	Praxair, Inc.	-0.07	0.30	1.46	0.18	0.35	3.33	0.31	5.87
70	Gaiam, Inc.	-0.07	1.53	1.46	0.18	-0.88	3.33	0.31	5.86
71	Genentech, Inc.	3.91	-0.92	2.26	0.18	1.58	0.14	-1.41	5.75
72	St. Paul Travelers Companies, Inc. (The)	5.90	-0.92	1.46	0.18	0.35	0.14	-1.41	5.71
73	Cincinnati Financial Corporation	-0.07	1.53	-0.95	0.18	2.81	0.14	2.02	5.67
74	Tellabs, Inc.	-0.07	-0.92	1.46	0.18	2.81	0.14	2.02	5.62
75	Sterling Bancshares, Inc.	1.92	1.53	-0.14	0.18	1.58	0.14	0.31	5.52
76	Procter & Gamble Company	-0.07	0.30	4.67	0.18	1.58	-1.45	0.31	5.52
77	Stanley Works (The)	-0.07	-0.92	1.46	0.18	2.81	1.74	0.31	5.50
78	Northwest Natural Gas Company	-0.07	0.30	1.46	0.18	1.58	1.74	0.31	5.50
79	United Parcel Service, Inc.	-0.07	0.30	1.46	0.18	1.58	1.74	0.31	5.50
80	Autodesk, Inc.	1.92	-0.92	2.26	0.18	1.58	0.14	0.31	5.47
81	UCBH Holdings, Inc.	1.92	0.30	2.26	0.18	0.35	0.14	0.31	5.47
82	Unisys Corporation	-0.07	-0.92	2.26	0.18	0.35	3.33	0.31	5.44
83	BEA Systems, Inc.	3.91	-0.92	1.46	0.18	0.35	0.14	0.31	5.43
84	State Street Corporation	3.91	1.53	2.26	0.18	0.35	0.14	-3.12	5.26
85	Quest Diagnostics Incorporated	-0.07	-0.92	2.26	0.18	1.58	0.14	2.02	5.19
86	National Semiconductor Corporation	1.92	-0.92	-0.14	0.18	0.35	1.74	2.02	5.14
87	Synovus Financial Corp.	-0.07	0.30	1.46	0.18	2.81	0.14	0.31	5.13
88	Total System Services, Inc.	-0.07	0.30	1.46	0.18	2.81	0.14	0.31	5.13
89	Adaptec, Inc.	-0.07	1.53	1.46	0.18	1.58	0.14	0.31	5.13
90	PeopleSupport, Inc.	-0.07	1.53	1.46	0.18	1.58	0.14	0.31	5.13
91	Citigroup Inc.	5.90	-0.92	3.87	-4.41	0.35	1.74	-1.41	5.11
92	Student Loan Corporation	5.90	-0.92	3.87	-4.41	0.35	1.74	-1.41	5.11
93	Columbia Banking System, Inc.	1.92	1.53	0.66	0.18	0.35	0.14	0.31	5.09
94	Sterling Financial Corporation/WA	1.92	1.53	0.66	0.18	0.35	0.14	0.31	5.09
95	Lexmark International, Inc.	-0.07	-0.92	2.26	0.18	1.58	1.74	0.31	5.07
96	Itron, Inc.	-0.07	0.30	0.66	0.18	0.35	3.33	0.31	5.06
97	Allied Capital Corporation	-0.07	-0.92	0.66	0.18	2.81	0.14	2.02	4.82
98	Federal Agricultural Mortgage Corporation	-0.07	0.30	0.66	0.18	1.58	0.14	2.02	4.82
99	MGIC Investment Corporation	-0.07	0.30	0.66	0.18	1.58	0.14	2.02	4.82
100	Tiffany & Co.	-0.07	-0.92	1.46	4.77	-0.88	0.14	0.31	4.81

The above table is computed from data provided by the KLD 2006 Stats database. This database includes U.S. firms from the Russell 3000, the S&P 500, and the Domini 400. KLD compiles a list of multiple strength items and multiple concern items in each of seven CSR categories; Community, Corporate Governance, Employees, Environment, Diversity, Human Rights, and Products. A firm receives one strength point or one concern point for each item that pertains to it. We sum the total strength points and subtract the sum of the total concern points by category for each firm to arrive at a net score by cat-

egory for each firm. We then standardize these scores by determining the standard deviation from the mean, by category. The values in the table above are the number of standard deviations that each firm's net score falls above or below the mean in each category. To arrive at our ranking, we then use an unweighted sum of all seven categories. This methodology is similar to the one used to compile the *Business Ethics* magazine 100 best Corporate Citizens of 2006.

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