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**Corporate Social and Financial Performance:  
The Case of Companies in Israel**

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## ACRONYMS

BSR	Business for Social Responsibility
CEO	Chief Executive Officer
CFP	Corporate Financial Performance
CRO	Corporate Responsibility Officer
CSP	Corporate Social Performance
CSR	Corporate Social Responsibility
DJSI	Dow Jones Sustainability Index
EVA	Economic Value Added
FP	Financial Performance
IBE	Institute of Business Ethics
KLD	Kinder, Lydenberg, Domini
MAALA	Business for social responsibility in Israel
MVA	Market Value Added
P/E	Price to Earnings ratio
RBV	Resource Based View
ROA	Return On Asset
ROE	Return On Equity
ROI	Return On Investment
ROS	Return On Sales
SEC	Securities and Exchange Commission
SP	Social Performance
SRI	Socially Responsible Investing
S&P 500	Standard & Poor 500
TA 100	Tel Aviv 100
TASE	Tel Aviv Stock Exchange
TRI	Toxics Release Inventory



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FACULTY OF EDUCATION

ABSTRACT

DOCTOR OF PHILOSOPHY

**CORPORATE SOCIAL AND FINANCIAL PERFORMANCE: THE CASE OF  
COMPANIES IN ISRAEL**

By YESHAYAHU SHAIKE MAROM

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This research sought to find local evidence within the Israeli context that corporate social responsibility can have positive impact on corporate financial performance, similar to research findings in leading western economies. Such local based evidence, if found, would encourage the inclusion of CSR as part of strategic management of companies in Israel. The investigation focused on a sample of leading companies in Israel, forming part of the TA-100 stock exchange index, and was undertaken between 2005 and 2006.

The research used quantitative investigation of secondary data on financial performance that is available for companies traded on the stock exchange. It included social responsibility ranking undertaken by the association of 'Business for social responsibility in Israel' – MAALA. This data was used to compare financial performance between groups of companies with different levels of social responsibility.

The research found that higher social responsibility for companies in Israel was associated with higher financial performance, in comparison to their counterpart companies ranked as lower in social responsibility. However at the extreme, a very high level of social responsibility is associated with decline in financial performance.

The research conclusion was that companies in Israel face the same CSR-to-CFP relationship, as their counterparts in leading western economies. This provides the rationale for Israeli companies to incorporate social responsibility as part of their business strategy aimed at improving financial performance.

## **Chapter 1 Introduction**

This research investigated the relationship between corporate social responsibility (CSR) and corporate financial performance (CFP) for corporations in Israel. My investigation was undertaken between 2005 and 2006 and it involved 100 companies which were based in Israel and traded in the Tel-Aviv Stock Exchange (TASE).

This chapter provides an initial outline of the subject, then it explains the content and structure of the thesis.

### **Corporate Social Responsibility**

"Corporate social responsibility encompasses the economic, legal, ethical, and philanthropic expectations placed on organizations by society at a given time" (Carroll and Buchholtz, 2000: 35). This statement implies that a corporation's conduct in a socially responsible fashion aligns business operations with social values through balancing and integration of economic, environmental, and social imperatives (Carroll, 1979, 1991, 1999, 2000). CSR can take many forms and dimensions such as activities in support of community well-being through voluntary helping to solve social problems such as education, health, youth development; protecting human rights, providing safe and good working environment for employees, fair and ethical trading, and preventing environmental harm (Crane and Matten, 2004: 50).

The concept of CSR is central to my thesis. Definitions of CSR have changed over time with arguments whether or not corporations should be engaged in social responsibility. On the one hand there were claims that corporations should not be involved in social responsibility at all. Friedman's (1962: 133-134) position was that corporations have one obligation which is maximizing profits, stating that "few trends could 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 stockholders as possible". However, Samuelson (1971: 24) presented the opposite position which supports a firms' engagement in CSR, stating that "a large

corporation these days not only may engage in social responsibility, it had damn well better try to do so".

CSR has become a contested issue developing into contradicting view-points not only with regard to the question of whether to be socially responsible, but also to questions about how should corporations do so, and to what extent. Some scholars introduced moral reasoning as the drive for CSR. This was based on the viewpoint that the activities of corporations cause social and environmental problems and hence they have a responsibility to solve those problems (McGuire, 1963; Davis and Blomstrom, 1966; Carroll, 1979). Others claimed that by including social responsibilities within their overall business strategy, corporations actually promote their own business interests. For example, Orlitzky et al., (2003) suggested that CSR activities can be rewarded by generating more satisfied customers, attracting better employees, improving reputation, forestalling hurtful legislation, and promoting long-term investment by the financial markets. The results of these consequences, it is argued, thus lead to improved financial performance for corporations.

Whether corporations should adopt social responsibility conduct at all, and to what extent, are the sorts of issues that are dealt with in the thesis. My chapter 2 will explore the concept of CSR in-depth, and I explore it within the Israeli business setting.

### **CSR Impact on Financial Performance**

It has been suggested that CSR might have an impact on the corporate financial performance (CFP), and presented several models and theories to explain such impact (Preston and O'Bannon, 1997; Margolis and Walsh, 2001). The relationship between CSR and CFP is central to my research, and an understanding of these theories is necessary in order to appreciate the research design and findings. Therefore the central models and theories related to the issue will be explored in Chapter 3. These include:

*The trade-off hypothesis* Presented by Preston and O'Bannon (1997) explains the negative impact of CSR on financial performance. The model emphasizes the costs of producing social outputs, which consequently reduce profitability. According to this

hypothesis the additional costs involved in achieving higher level of social responsibility are subtracted from the net earning and thus reduce the level of profit and other financial performance indicators.

*The stakeholder theory of the Firm.* This theory is instrumental in understanding some of the models regarding the positive impact of social responsibility on financial performance. According to Freeman (1984: 46) a stakeholder has been defined as “any group or individual who can affect or is affected by the achievement of the organization’s objectives”. Within this definition, typical groups that are referred to as stakeholders include customers, employees, suppliers, local communities, governments, shareholders, and even the environment. The stakeholder theory suggested that corporations should look beyond profit maximization for their shareholders, and take into consideration other stakeholder groups. The stakeholders that the corporation is associated with can claim a legitimate interest in an organization and its work through an impact that they have on an organization (Preble, 2005).

*Stakeholder Management.* The stakeholder theory has led to the recognition that managerial attention should be directed at the stakeholders' expectations, to prevent negative impact and enhance positive impact on the corporation performance (Preble, 2005). Managing relationships with primary stakeholders - dubbed 'Stakeholder Management' (Donaldson and Preston, 1995) - can constitute intangible, socially complex resources that may enhance firms' ability to outperform competitors in terms of long-term value creation (Hillman and Keim 2001). This could lead to a positive impact of social responsibility on financial performance.

*Social impact hypothesis.* The 'Social Impact' hypothesis (Preston and O'Bannon, 1997) follows the stakeholder theory by assuming that meeting the expectations of various stakeholders groups will result in better financial performance, and vice versa. It emphasizes a proactive approach to dealing with the stakeholders, as opposed to a more responsive approach of stakeholder management. In a similar vein, Cornell and Shapiro (1987) argue that failure to meet the expectations of various non-shareowner constituencies will generate market fears, which, in turn, will increase a company's risk premium and ultimately result in higher costs and/or lost profit opportunities.

According to Cornell and Shapiro (1987) serving the implicit claims of major stakeholders enhances a company's reputation in a way that has positive impact on its financial performance; conversely, disappointing these groups may have negative financial impact.

*Resource-Based View.* The resource-based view (RBV) holds that firms possess resources, capabilities and competencies which enable them to achieve competitive advantage. Such competitive advantage can be sustained for a long period depending on the firm's ability to protect against resource imitation, transfer, or substitution (Rumelt, 1984; Wernerfelt, 1984; Barney, 1991; Peteraf, 1993). The resource-based view of the firm offers an excellent theoretical perspective to explain how corporate social responsibility can lead to better financial performance, because it explicitly recognizes the importance of intangible concepts, such as corporate culture (Barney, 1986), and reputation (Hall, 1992; Russo and Fouts, 1997) in creating strategic competitive advantage. The reputation perspective regarding business activity proposes that actions of social responsibility may help build a positive image with stakeholder groups including customers, investors, and suppliers (Fombrun and Shanley 1990). The implications of this perspective are that firms with a higher reputation may improve their access to capital (Spicer 1978); or attract better employees (Greening and Turban 2000) or increase current employees' motivation, which in turn may improve financial performance (McGuire et al. 1988; Waddock and Graves 1997).

*Non-linear Relationship.* A major drawback of the negative and positive impact theories is that they do not allow for non-linear results (Moore, 2001). For example a possible relationship could be an inverted U relationship, which was the result in the studies by Bowman and Hire (1975) and Sturdivant and Ginter (1977).

I have contributed to this debate by proposing a 'Unified Theory'. My work sought to integrate the costs of social responsibility together with the rewards from satisfied stakeholders. My work has drawn on previous publications by Jones (1995) and McWilliams and Siegel (2001), suggesting supply and demand model of CSR. The unified theory can explain a non-linear relationship between CSR and CFP, including positive and negative segments.

The various models and theories about the relationship between CSR and CFP will be explored in chapter 3, and create the theoretical perspective for this research.

### **Previous Empirical Research**

Considerable research has been published on the relationship between corporate social responsibility and financial performance (Griffin and Mahon, 1997; Margolis and Walsh, 2001; Orlitzky et al., 2003). For example, Margolis and Walsh (2001) have identified 95 empirical studies that were published on this subject between 1972 and 2000. However there has been great variability within this body of research, mainly with regard to the following key issues (Griffin and Mahon, 1997):

- Variability in the theoretical perspective (Griffin and Mahon, 1997; Orlitzky et al., 2003);
- Many differences in operationalisation and measurements of the variables (Griffin and Mahon, 1997; Margolis and Walsh, 2001);
- Inconsistency in results and conclusions about the relationship between CSP and CFP (Griffin and Mahon, 1997);

These issues relating to the design of previous research are thoroughly investigated, aiming to reach an understanding that will facilitate the design of my research. This investigation is elaborated through chapter 4 of the thesis.

### **Context Setting**

When I started my Ph.D., my occupation was that of a business consultant working in business development and strategy, utilizing my formal knowledge in business administration. My work, in conjunction with many executives of companies, was to devise business strategies that would lead to sustainable strategic advantage and thus maximize financial performance.

Keeping up with new developments in my professional field, I have read about developments concerning the implementation of corporate social responsibility to advance business goals. This gave me familiarity with the research area of corporate

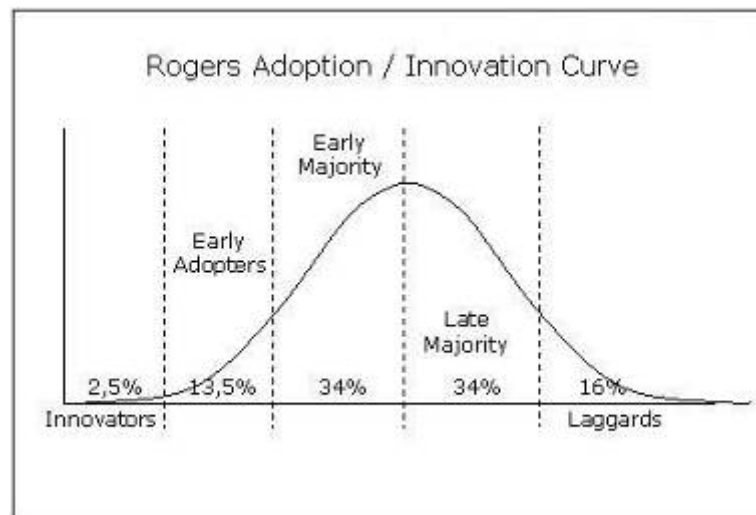
social responsibility and its impact on financial performance. It has become apparent to me that the issue of relationships between CSR and CFP are critical issues for my professional work. The significance of this is because the notion contributes to building competitive advantage for companies operating in highly competitive local and global markets. Thus, this topic was not only a matter of personal and professional interest to me but also because it had a wider relevance and importance for companies in Israel.

At the same time there has been a growing managerial awareness amongst executives of companies in Israel as to CSR and its potential to contribute to competitive strategy and improved financial performance. This was a new idea to those utilizing the classical models like SWOT (Strengths, Weakness, Opportunities and Threats), BCG (Boston Consulting Group Matrix), the resource-based view (RBV), and Porter's 'Five Forces' model. These ideas diffused through interaction with international corporate management and caught the attention of first adopters amongst Israeli managerial community.

The phenomenon can be explained by the 'Diffusion of Innovations' theory (Rogers, 2003), which explains the process by which an innovation is communicated and absorbed. The theory suggests that innovations are absorbed gradually through a chain of adopter categories – Innovators, Early Adopters, Early Majority, Late Majority, and Laggards (see Figure 1.1: 7). According to the theory, some managers who fall under the category of 'early adopters', are on the lookout for a strategic leap forward and are quick to adopt new ideas to advance their business. Often they will grasp at innovations on the basis of no more than a well-worded news article. For such managers, early information from abroad, about the potential benefit of social responsibility, is enough to adopt such practice.

However, the majority of managers, who fall in the categories of 'Early and Late Majority', would not adopt it at first without solid proof of benefits. Accordingly, these managers will look for a guaranteed practice which has already been proven in a setting that is applicable to their business. Thus, such majority of managers will be susceptible to adopt CSR practice if it has been the result of research and proven results in their local business environment. However, when I undertook this research,

such evidence coming from the Israeli business environment did not exist. The main contributors to the concept of CSR and its impact on financial performance came from outside Israel. These ideas were tested in studies undertaken elsewhere and thus the applicability to the local industry in Israel had not been studied. At the time that I started the research, there were no studies carried out by Israeli researchers, dealing with companies who operate from Israel.



**Figure 1-1 Adoption Innovation Curve**

The fact the local corporations exercised actions of social responsibility, which was not based on findings from their local operating environment, indicates a potential gap in knowledge. It is assumed that managerial practice promotes actions based on concrete and relevant knowledge and data. However, received wisdom is supported by my personal direct experience that this has not been the case for social responsibility actions by corporations in Israel. Where it occurs, it appears to be ad hoc and is a response to a variety of stimuli (Reichel, A. et al. 2000; Guttman-Schwartz and Gadot, 2003). The absence of professional managerial commentaries or empirically-based articles in peer-reviewed journals on this topic, indicate that the subject has been recognized by academics as worthy of investigation rather than by practitioners in the field. Thus, the topic has emerging contemporary relevance and is as worthy of investigation as a gap in understanding to demonstrate how it is perceived by senior managers. My research will contribute knowledge about this area of social responsibility impact on financial performance in Israel, contributing vital



information that will allow the majority of managers to accept the practical use of social responsibility, as suggested by Rogers (2003).

Although corporations in Israel started to attribute high importance to social responsibility, the issue of its impact on financial performance has not been locally investigated for several reasons. First, management adopted a 'by similarity' practice assuming that external findings are relevant to the local social and business environment. Second, such collective investigation would normally be driven and supported by a local nonprofit organization, which did not exist by the early 2000. Thirdly, there has not been a social responsibility measurement system in Israel, which was started only during 2004, and is a critical enabler for such investigation. Thus, there has been lack of local-based data on CSR performance as well as their impact on financial performance.

For these reasons, the impact of social responsibility actions in Israel, by Israeli companies, and the correlation between it and their financial performance represents a topic worthy of serious investigation. My personal involvement in devising corporate strategy perspectives for firms in Israel, coupled with my recognition of this gap in knowledge, encouraged me to select it as the topic for my doctoral research.

### **Research Question**

The general issue addressed in this thesis is the relationship between corporate social responsibility and financial performance for companies in Israel, which were listed in the Tel Aviv Stock Exchange TA-100 index of the top 100 companies in Israel for 2005 and 2006. This is conceptualized in terms of the existing literature on social responsibility, and correlation to financial performance and is addressed as a series of research questions below:

- Does corporate social responsibility have a positive impact on corporate financial performance;
- Does the relationship between CSR and financial performance follow the rationale suggested by the 'Unified Theory';
- Does industry sector have an affect on the relationship between CSR and CFP;

Answers to these questions will generate evidence to fill the gap in knowledge regarding the relationship between CSR and CFP for companies in Israel.

### **Structure of the Thesis**

The literature review needed to build the theoretical framework for the thesis is discussed in chapter 2 to 4.

In chapter 2 the concept of corporate social responsibility, which is the core concept for this thesis, is then explored. The evolution of this concept is presented as well as investigation of different viewpoints, which leads to the formulation of the concept as it will serve for the thesis.

I then consider how corporate social responsibility affects the corporate financial performance. This investigation is provided in chapter 3, which presents the main theories that govern this relationship. The understanding of the relationship between corporate social responsibility and financial performance serves to build the conceptual framework of the research, as it is aiming to investigate such a relationship in a specific context.

An understanding of the way past empirical research on this issue will serve for the design of my research. Thus, a review of past research is presented in chapter 4 identifying differences in conceptual frameworks, operationalisation of variables, and measurement issues. This understanding of past research will support the identification of the best approach for my research.

Building on the theoretical perspective that has been built through chapter 2 to 4, the design of the current research is brought in chapter 5. The research design is grounded in the conceptual framework and includes the methodology, methods, operationalisation and measurement of the variables, and data collection. The research has been carried out accordingly.

The results of the data collection are reported in chapter 6. The chapter presents all the data collected as well as numerical analysis. The results are discussed and interpreted

according to the research design, leading to having a comprehensive view of all the results.

With the results at hand, chapter 7 brings us to the discussion about their meaning and interpretations. Final conclusions are drawn based on the interpretation, and against the background of the theoretical perspective.

Chapter 8 provides Interpretation of the research. It does so by using Rose (1982: 14) model to interpret my research from the perspectives of external validity, plus internal theoretical validity and internal empirical validity. It also suggests meanings that can be drawn from the research results.

Finally, chapter 9 offers descriptive and conceptual conclusions. It follows principles suggested by Trafford and Leshem (2008: 170) to cross-link between the beginning and the end of the research. Thus, possible conclusions are portrayed against the background of the initial research hypothesis, bringing the thesis to its closure.

### **Chapter Summary**

This chapter introduced the research problem. It went on to elaborate on the content of the thesis which will include a literature review investigating the main concepts and theories, as well as past research on the issue; all leading to the research itself. This will be followed by the research itself including the design and results; and finally the discussion, conclusion, and summary. Next, chapter 2 will start the part of theoretical perspective, by investigating the concept of corporate social responsibility.

## **Chapter 2 Corporate Social Responsibility**

### **Introduction**

The concept of corporate social responsibility, which is the core concept of my research, is investigated in this chapter. It aims to arrive at an understanding of the scope of the concept as it is currently perceived. This is achieved by following the evolution of the concept, identifying changes in emphasis as well as alterations and elaboration of the concept. Thus, the evolution of this concept is reviewed, and different viewpoints are introduced, leading to the formulation of the concept as it will serve for the thesis.

### **The Conceptual Development of CSR**

The concept of corporate social responsibility (CSR) has evolved over time (Carroll, 1999). According to Carroll this occurred mainly during the last fifty years, and was influenced by parallel developments in other areas of modern life. Developments in world economics and the business domain, as well as in the social aspects and environmental awareness, had an influence on how the concept of CSR developed.

By the mid of the 20<sup>th</sup> century, Bowen (1953), sometimes regarded as "Father of Corporate Social Responsibility" (Carroll, 1999: 270), proposed one of the early definitions of social responsibility. In his book 'Social Responsibility of the Businessman' he suggested that "It refers to the obligations of businessmen to pursue those policies, to make those decisions, or to follow those lines of action which are desirable in terms of the objectives and values of our society" (1953:6). Also referring to it in terms of 'Social Consciousness', he went on to explain its meaning "... that businessman were responsible for the consequences of their actions in a sphere somewhat wider than that covered by their profit-and-loss statements" (1953:44).

Stemming from the content of that definition and the language it uses the following understandings and implications are apparent. First, it is drawing on moral reasoning, as suggested by the approach of social obligations in alignment with values of society. This is also apparent from the language which uses the expression 'social

consciousness' as a synonym to 'social responsibility'. Such moral reasoning was shared by many authors of the mid 20<sup>th</sup> century, and preceded the business oriented approach (Crane and Matten, 2004: 40). Second, the language used by Bowen (1953), using the expression of 'businessman' in conjunction with 'social responsibility', and not relating to 'corporate' social responsibility, stresses the obligations of individual businessmen as opposed to the responsibility of the corporations that were used in later definitions.

In contrast to the moral approach taken by Bowen (1953), Davis (1960) has hinted at the possibility of business worthiness that can be found in actions that are associated with social responsibility. In defining social responsibility he refers to "businessmen's decisions and actions taken for reasons at least partially beyond the firm's direct economic or technical interest" (1960: 60) As suggested by the word 'partially' in this definition, Davis argued that some socially responsible business decisions can be justified as having a good chance of bringing long-run economic gain to the firm, thus paying it back for its socially responsible conduct. Thus, Davis (1960) has also been a pioneer in his assumption that social responsibility can lead to improved financial performance on the long-run, a notion that has become recognized later on during the 1980s, as indicated by Carroll (1999: 271).

At this point, several authors contributed to make the definition more comprehensive. McGuire (1963) has strengthened the definition by highlighting the economic and legal facets of social responsibility, followed by Walton (1967) who introduced an essential ingredient to social responsibility by arguing that it should be based on voluntarism. He also added that costs invested in CSR may not be easily traced as to their economic returns. With this notion he hinted that social responsibility might have a positive impact on business profitability. Thus he was advancing similar ideas to those presented earlier by Davis (1960).

While Davis and Walton raised the possibility that social responsibility might contribute to the business ends, it was Johnson (1971: 73) who first said so explicitly. Johnson's (1971) added two components to the understanding of the CSR concept. First, he identified a possible causation between managers' engagement in CSR, which he called 'conventional wisdom', and financial performance. He referred to this

in his view that "social responsibility states that businesses carry out social programmes to add profits to their organization" (1971: 54). Second, he was among the first to identify the stakeholders of the firm in his CSR definition, by stating that "A socially responsible firm is one whose managerial staff balances a multiplicity of interests. Instead of striving only for larger profits for its stockholders, a responsible enterprise also takes into account employees, suppliers, dealers, local communities and the nation" (1971:50).

Although the idea that social responsibility might contribute to the profit of the organization, as advocated by several authors (Davis, 1960; Walton, 1967; Johnson, 1971) became more outspoken when others such as Eells and Walton (1974), continued to stress the moral aspect of the concept. Eells and Walton said that the existence of corporation is dependable on their adherence to social responsibility and provided a unique definition of CSR by adopting a wide social perspective as a basis for their approach. Their view on CSR was that:

*"In its broadest sense, corporate social responsibility represents a concern with the needs and goals of society which goes beyond the merely economic. Insofar as the business system as it exists today can only survive in an effectively functioning free society, the corporate social responsibility movement represents a broad concern with business's role in supporting and improving that social order" (1974:247).*

Carroll (1979) suggested the most comprehensive definition of CSR, which is still valid and widely used in contemporary research (Crane and Matten, 2004: 42-43; Visser, 2005). Carroll (1979) introduced a three-dimensional model, dubbed the 3-D model, which is presented next.

### **The 3-D Model**

Carroll (1979) model brought together factors which had previously either been overlooked or treated as independent influences on CSR. Thus, by creating this model he unified thinking about CSR within a new paradigm that expanded understanding about this aspect of business practice.

At the top level of the model, CSR is said to have the following three dimensions:

The main components of his model were:

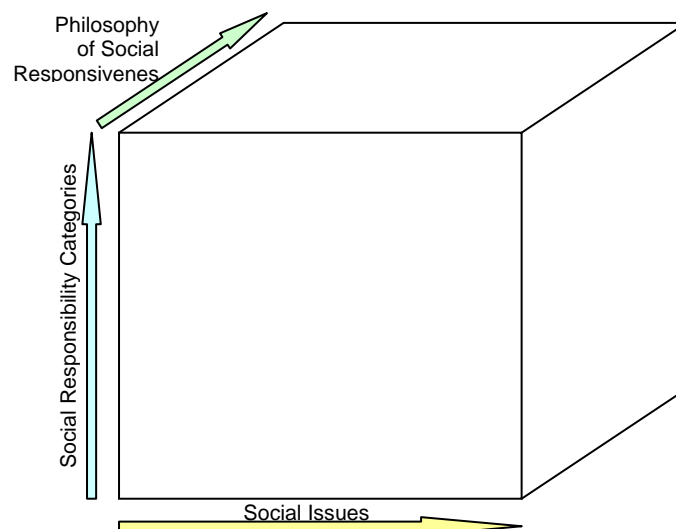
1<sup>st</sup> dimension: social responsibility categories;

2<sup>nd</sup> dimension: social issues involved;

3<sup>rd</sup> dimension: the philosophy of social responsiveness.

The three dimension concept illustrates the fact that each dimension can be configured separately, irrespective of the other two. Thus, the dimensions are independent, however together they form the complete CSR posture of any given firm. These three dimensions have been depicted as a 3-D cube by Carroll (1979) as shown in Figure 2-1, and their meaning are explained hereafter.

The 3-D Model of CSR/CSP (after Carroll, 1979)



**Figure 2-1 The 3-D Model of CSR/CSP (after Carroll, 1979)**

*1<sup>st</sup> dimension: The social responsibility categories – CSR Pyramid*

The first dimension, which is regarded as the core of the concept, breaks CSR into four categories. According to Carroll (1979: 500) "The social responsibility of business encompasses the economic, legal, ethical, and discretionary expectations that society has of organizations at a given point of time". Carroll (1979, 1991) suggested that the four categories of CSR can be depicted as a pyramid, as shown in Figure 2-2 (15).



**Figure 2-2 The Pyramid of CSR (Carroll, 1979, 1991)**

The pyramid is intended to portray that the CSR categories are built one on top the other, with each level providing the basis for the one above it. Such a pyramid construct conveys an understanding of dependence and immediacy similar to Maslow's hierarchy of needs (Maslow, 1970). Like Maslow, Carroll implies that his factors contain an ascending importance that becomes apparent when a lower-level factor is met and achieved and a 'higher' need takes its place. Accordingly, Carroll suggests that corporations have to fulfill their economic responsibility first, before moving on to legal responsibility and then to ethical and discretionary responsibility. Thus, his model, like that of Maslow's, contains an implicit dynamic of replacement, hierarchy, and progressive development.

Carroll's notion of social responsibility contained four elements. First, it is traditionally held that economic responsibility is the first and foremost responsibility of a corporation to society. This economic role of a corporation is central to its survival and its on-going functioning within society. Thus, the satisfaction of economic responsibilities is a pre-requisite of all corporations that is achieved through sustainable profits and competitive market position.

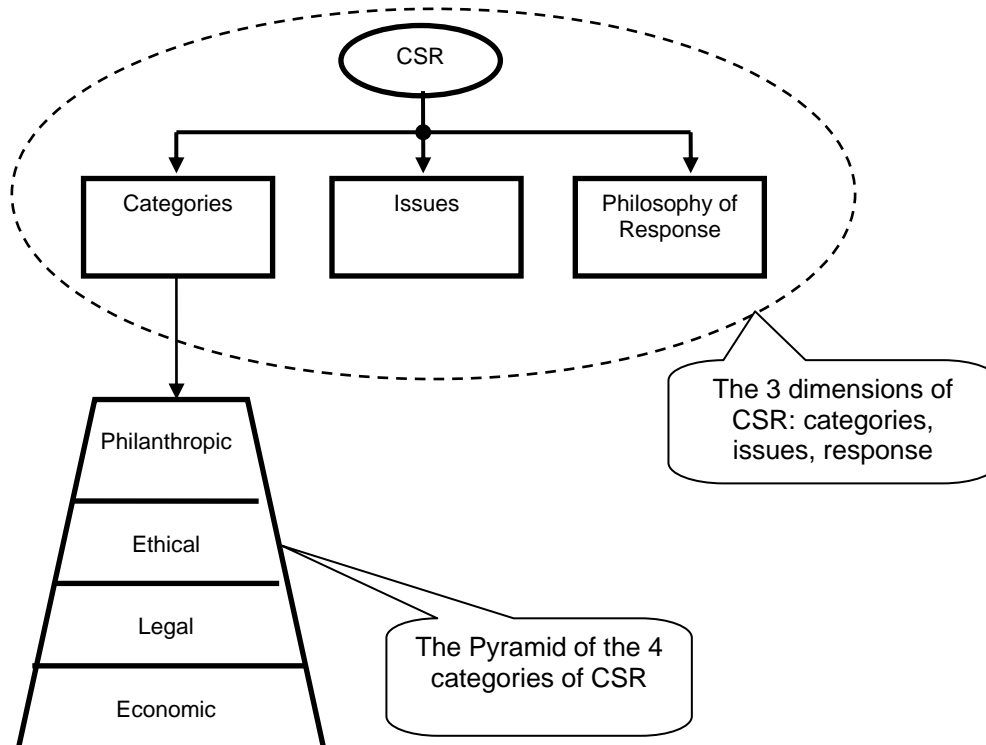
Second, is the legal responsibility which assumes that corporations have to carry out their economic responsibilities while operating in accordance with the laws and societal regulations. The components of legal responsibilities include adherence with law and regulations.



Third, is the ethical responsibility that is placed on businesses. Corporations are expected to conduct their business in a just and fair way according to norms anticipated by society, although such norms are not always codified in laws and regulations. Ethical responsibilities therefore consist of what is generally expected by society over and above the economic and legal requirements.

Fourth, is the category of discretionary responsibility. As the name implies, these are roles that businesses are voluntarily engaged in because they chose to have a social role. Also referred to as 'Philanthropic Responsibility', these social responsibility activities can include social programmes within the community, such as education and health.

The above four categories of social responsibility provide the framework for all the activities of corporate social responsibility, and are therefore taken into consideration in the definition of the concept of social responsibility for my research. The linkage of the pyramid of four categories of CSR to the 3-D model is depicted in Figure 2-3.



**Figure 2-3 The 3-D model and 4 categories of the 1<sup>st</sup> Dimension**

### *2<sup>nd</sup> dimension: The social issues involved*

Carroll's second dimension encompasses the social issues that corporate social responsibility has to deal with. Examples of social issues mentioned by Carroll include occupational safety and health, employment discrimination, product safety, and consumerism. However, he noted that social issues change over time and differ for various industry sectors. This reflects changes in society and issues rendering importance to companies. Therefore, the identification of specific social responsibility action is a task that my thesis will address later-on, in this chapter as well as in chapter 4, to adjust to the specific time frame in which it was conducted.

### *3<sup>rd</sup> dimension: The philosophy of social responsiveness*

The third component of Carroll's (1979) model deals with how corporations respond to social issues and expectations. This has also been referred to as 'Social Responsiveness' by Davis and Blomstrom, (1975), Frederick (1978), Carroll (1979) and Wood (1991). They argued that corporate social response can range from no response, through defence and accommodation, to proactive response. This dimension of the 3-D model has little importance to my thesis and therefore is mentioned to illustrate the wholeness of the model, but without further discussion.

Despite the plethora of CSR definitions over the last 50 years, Carroll's model for CSR, and more-so the pyramid of four categories of CSR, has been the most durable and widely cited in the literature (Crane and Matten, 2004: 42-43; Visser, 2005). This model will serve also this thesis, but not before updating it in time, as suggested by Carroll himself. The advances in time of the concept of social responsibility and its components will be presented after the critique on Carroll's model which is next.

## **Critique on Carroll's Definition of CSR**

Although Carroll's definition of CSR has been the most durable and widely cited in the literature, it has been criticized as well. Visser (2005) claims that Carroll's CSR Pyramid has two major limitations - it lacks conceptual clarity and descriptive accuracy.

With regard to the lack of conceptual clarity, Visser (2005) shows that it is not clear why CSR is depicted as a hierarchy, citing various explanations given or implied by

Carroll himself. Such explanations include rationales based on historic development, order of dependence, and relative perceived importance assigned by managers. Visser claims also that Carroll is trying to establish an umbrella concept which "attempt to conflate various allied concepts such as business ethics, corporate citizenship and stakeholder management into his own CSR Pyramid". This blending of themes fails to create a clear concept.

With regard to descriptive accuracy, several authors (Crane and Matten, 2004: 42-43; Visser, 2005) contested the universality of the model, as claimed by Carroll, by pointing out that it had not been properly tested in contexts outside the commercial practices dominant in America. For example, Visser (2005) argued that the order of the layers of Carroll's model is found to be different in the context of Africa. Other scholars (Edmondson et al., 1999; Burton et al., 2000) also assign different relative importance to the layers of the model, in different contexts.

Thus, it has been suggested by this critique that Carroll's CSR model may not be the only or best one to describe and use for CSR.

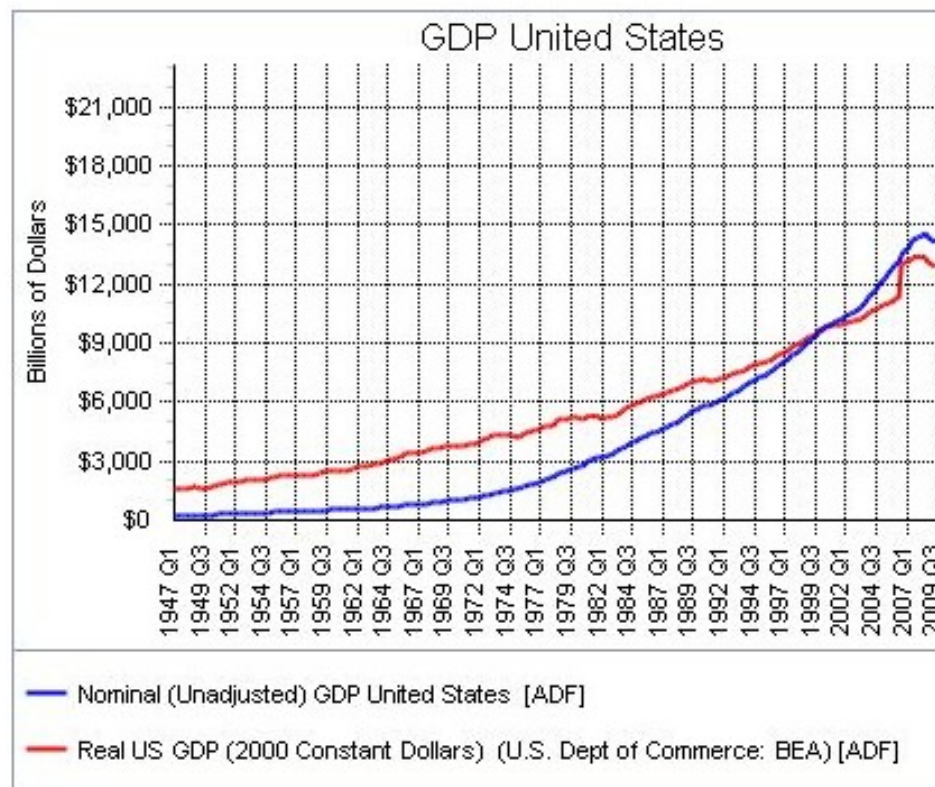
### **The Evolution of CSR since the 1980s**

Significant global developments and trends since the 1980s have influenced further evolution of the concept of corporate social responsibility (Carroll, 2004). With the Carroll 3-D model of CSR continuing to serve as a base definition for CSR, other authors have used it as point-of-departure for related concepts and refined definitions reflecting emphasis shift of the era. Additional dimensions of social responsibility, as well as alternative themes and concept, such as Corporate Citizenship, Environmental Responsibility, Human rights, and Corporate Governance, have seen rise during this period. With the need for my research to use contemporary dimensions of corporate social responsibility, and to account for the various dimensions of social responsibility, these new themes and their driving forces are discussed.

#### *Corporate Citizenship*

One of the trends of this more recent era (past 1980s) is the economic growth and the rise of the powerful corporations. This era was marked by a steep economic

development worldwide, which continued on through the 1990s. As an indicator to this, one can look at the data from the U.S.A., which was a main contributor to the global. The gross domestic product (GDP) of the U.S.A. increased dramatically from 2,800 billion dollars in 1980, to 6,000 billion dollars in 1990 and reached nearly 10,000 billion dollars in 1999 (see Figure 2-4).



**Figure 2-4 U.S.A. GDP Growth Source: U.S. Dept of Commerce**

As part of this economic growth, and driving it, was a large number of big corporations (Lipartito and Sicilia, 2004). The top listed corporation on the 'Fortune 500' had a financial turn around in order of magnitude similar to the GNP of many countries. This situation brought two implications with an impact on social responsibility. The rise of the powerful corporation was reflected also in a newly coined phrase of 'Corporate America'.

Corporate America is an informal phrase describing the world of corporations within the United States which are not under government ownership. The phrase also has attracted negative connotations which imply financial or ideological self-interest, greed, resistance to entitlements and the irresponsible promotion of counter-socialist

self-interest at the expense of government, competitors, and citizens (Uchil, 2005). This self-interest of the large corporations evoked pressure from communities and legislators toward corporations demanding that they be more conscious of their impact on the society. Thus, corporations faced an increased demand that they should incorporate social responsibility in their conduct (Lipartito and Sicilia, 2004).

Moreover, with the vast amount of money under their hands, corporation now had considerable power at their disposal, which was once only in the hands of governments. Thus, this brought additional pressure for companies to use some of their wealth to create wealth for the community which the corporations relied on (Lipartito and Sicilia, 2004). This trend was seen as supporting the positive connotations of 'Corporate America' by implying that corporations could create wealth to society, directly and indirectly, and lift the people's standard of living.

This led to the development of the theme of 'Corporate Citizenship' as part of, or an alternative to, the concept of social responsibility. Crane and Matten (2004: 61-63) explained that the use of the word 'citizenship' had a different connotation for business. It implies that corporations take their place in society, next to other 'citizens' with whom the corporations form a community. With this wider association of collegiality corporations take upon themselves to focus on the rights and responsibilities of all members of the community.

Under the term of corporate citizenship, corporations were expected to contribute more to the community and society as a whole than had previously been their custom. They were expected to be involved in discretionary activities within the community, beyond that which is expected of business. Such activities included philanthropic support, as well as employee voluntarism, in support of education and health programmes in the community (Crane and Matten, 2004: 61-63).

The theme of 'Corporate Citizenship', although having various interpretations, has brought forward the dimension of support to the community as a critical component of corporate social responsibility. Accordingly corporations are getting more involved in support activities in the community.

### *Environmental Responsibility*

Another significant trend since the 1980s is the growing awareness to the global environment and the need for protection and preservation of this life-sustaining asset (UN Intergovernmental Panel on Climate Change, 2007). This can be illustrated by a number of milestones, including catastrophic disasters such as the Bhopal mass poisoning, the Chernobyl nuclear reactor and the Exxon Valdez oil spills, ozone depletion and the greenhouse effect, depletion in natural resources, and extreme weather conditions (IPCC, 2007).

In 2007, the United Nations Intergovernmental Panel on Climate Change (IPCC) issued its third 'Climate Change Report' on global warming (IPCC, 2007). The report, prepared by 2,500 scientists from 130 countries, unequivocally states that the current trend is towards potentially catastrophic global warming induced by human activity. Although this change has begun with the dramatic increase in fossil fuel use during the Industrial Revolution of the mid-19th century, it is now accelerating much faster. The report brings evidence to the global warming, ice melting, and rise in the sea level, and highlights a number of consequences of climate change including more extreme weather, intense tropical storms, catastrophic flooding and higher sea levels.

According to the IPCC report, climate change can cause social effects that would include hundreds of millions of 'climate refugees' forced from devastated regions, and economic effects with overall costs and risks of climate change rising up to 20% of world GDP. This grim forecast brought a growing demand from the public and regulators that corporations increase their environmental responsibility (Porter and Van der Linde, 2000).

Environmental responsibility is about protection of the environment and preservation of natural resources (Perry and Singh, 2001). It can take many forms depending also on the industry type (Porter and Van der Linde, 2000). It can include such contemporary features as the use of clean energy, decreasing the environmental footprint through prevention and control of pollution discharges and emissions, avoiding ozone depleting chemicals, use of eco-friendly agricultural chemicals, wise use as well as conservation of scarce natural resources, recycling materials and waste, controlling hazardous waste and environment-friendly products (Eden, 1996).

Thus, in the contemporary framework of corporate social responsibility, environmental responsibility forms an important component. This component has been accounted for in my research.

### *Human Rights*

Since the 1980s' there has been a growing trend of globalization (Crane and Matten, 2004: 158, 214). Globalization is the development of an increasingly integrated global economy marked especially by free trade, free flow of capital, and the tapping of cheaper foreign labor markets (Merriam Webster Web Dictionary at [www.merriam-webster.com](http://www.merriam-webster.com)). This process has speeded up dramatically in the last two decades as technological advances make it easier for people to travel, communicate and conduct their business internationally. Two major recent driving forces for this are advances in telecommunications infrastructure and the rise of the internet as a medium for communications.

Legge (2000) pointed out that globalization of business practices has had a significant impact on the question of the ethical treatment of employees. In particular, there has been a perception of growing misconduct by Multi National Corporations (MNC) in the way they treated employees in developing countries. Globalization has led to the situation where many MNC in the western world would have transferred part of their manufacturing to low-wage countries to improve their financial competitiveness. However, this trend was often accompanied by questionable working conditions for those workers, such as low wages, high risks for health and safety and unsatisfactory working conditions that are judged to be inhumane (Legge, 2000).

The case of Nike, a leading manufacturer of sport shoes and clothing, was a classic example of this situation. The company faced allegations made with regard to working conditions in its factories in the Far East where the factories were Nike owned and operated, or merely sub-contractors working for Nike. Some reports on factories in Bangladesh found that Nike's employees were averaging 70 hours a week and were paid less than the equivalent of 20 U.S. cents an hour. Nike's reputation suffered a major blow from this revelation, and so it placed the issue of human rights of workers firmly into the public domain,

### *Corporate Governance*

Since the early 1990s onwards, major corporate corruption events hit 'Corporate America' including high-profile collapses, CEO dismissals, executive misconduct, massive bankruptcies, corruption and criminal malfeasance. In the first half of the 1990s, misconduct by certain top executives at companies like IBM, Kodak, and Honeywell, resulted in their CEOs being dismissed by their boards. At the same time a wave of institutional shareholder activism erupted with the purpose of ensuring that corporate value would not be destroyed by 'cozy relationships' between the CEO and the board of directors. Similarly, in the early 2000s, the massive bankruptcies of Enron, WorldCom and other companies, led to increased shareholder and governmental interest in corporate governance. Those events highlighted the need and importance of Corporate Governance, as an additional dimension of corporate social responsibility.

Corporate Governance is defined as the ways in which a firm safeguards the interests of its financiers including investors, lenders, and creditors (O'Donovan, 2003). Gabrielle O'Donovan went on to explain that corporate governance as "an internal system encompassing policies, processes and people, which serves the needs of shareholders and other stakeholders, by directing and controlling management activities with good business savvy, objectivity, accountability and integrity. Sound corporate governance is reliant on external marketplace commitment and legislation, plus a healthy board culture which safeguards policies and processes" (2003:23). Thus, Corporate Governance forms an important component of corporate social responsibility.

With the evolution of social responsibility since the 1980s, the concept of the CSR had been enhanced to include the dimensions of corporate citizenship, environmental responsibility, human rights, and corporate governance. With this update we have followed Carroll's (1979) suggestion that the exact social issues involved in CSR should be updated over time.

Accordingly, the contemporary construct of CSR by which it is measured (KLD, 2007; MAALA, 2007), includes the following dimensions:



*Employee Relations:* This dimension assesses the corporate performance in taking care for its employees. It includes issues such as labor management relations, anti discrimination policies and practices, and employee safety.

*Human Rights:* This dimension assesses the corporate performance with regard to labour rights of workers. It refers to the abuse of cheaper foreign labour markets and inhuman working conditions.

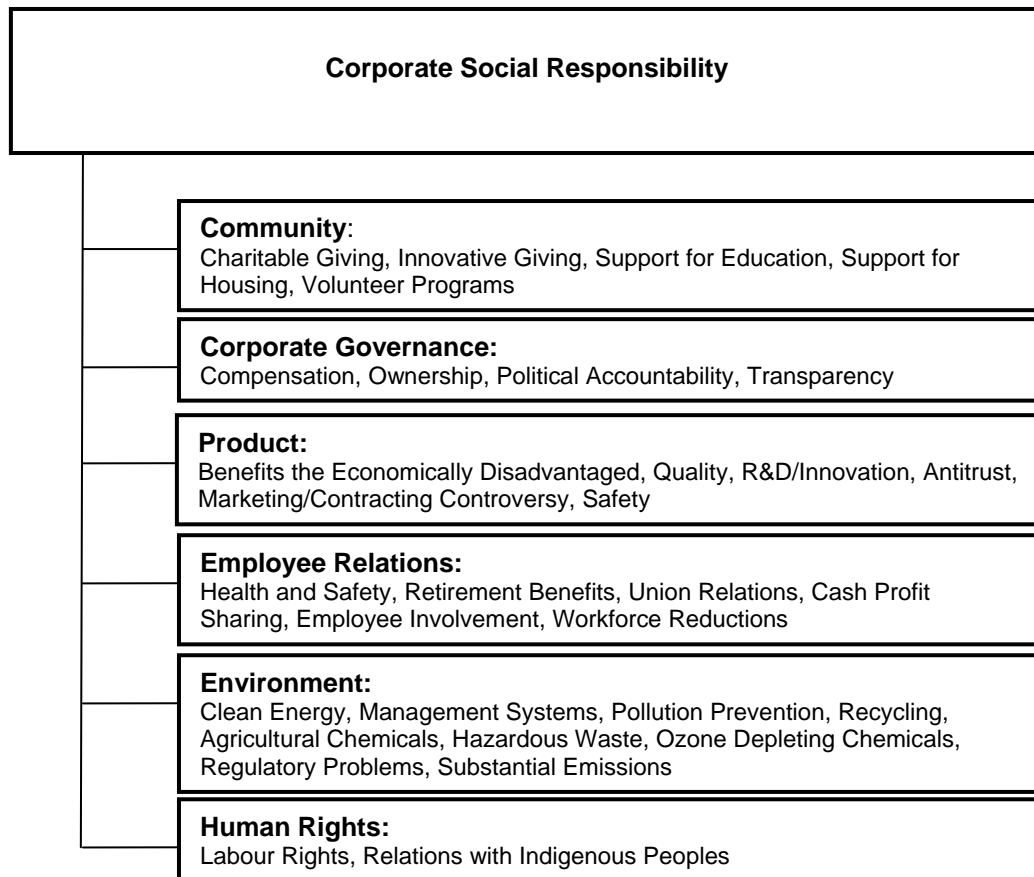
*Product:* This dimension assesses the corporate performance with regard to quality and safety of its products, as well as advertising practices and post-sell services.

*Environment:* This dimension assesses the corporate performance with regard to its environmental challenges, including its efforts to reduce and offset the impact of its operation and products on the environment.

*Community:* This dimension assesses the corporate performance with regard to contribution to the communities where it operates, including its treatment of local populations as well as contribution to education and health, and commitment to charitable giving.

*Corporate Governance:* This dimension assesses the corporate performance with regard to proper business conduct, including transparency and proper reporting to shareholders, accountability toward the public, and issues of corruption.

Those dimensions are depicted in Figure 2-5 (25).



**Figure 2-5 The dimensions of CSR (Source: KLD, 2009)**

### **Corporate Social Performance**

Several authors (Wartick and Cochran, 1985; Wood, 1991; Frederick, 1994) viewed CSR as a concept relating to principles of social responsibility, while the concept of corporate social performance (CSP) was regarded as the outcomes of social responsibility actions. Wood (1991) went on to suggest that the concept of CSP includes both the principles and outcomes. According to her definition the concept of CSP has three facets – principles, processes, and outcomes.

Because the concept of CSP relates to the outcomes of actions of corporate social responsibility, it fulfilled a centre role as a measurable construct of social responsibility within empirical research (Griffin and Mahon, 1997; Moore, 2001; Simpson and Kohers, 2002; Orlitzky et al., 2003). However, the dimensions of CSP, as presented in the previous paragraph, are identical to these of CSR, except the notion that CSR represents intentions while CSP is their measurable output. In other words, CSP is the measurable value of CSR, and in this respect they represent the

same concept. It is therefore that my research will use CSP as a measurable concept of CSR.

### **Chapter Summary**

The concept of corporate social responsibility gained noticeable recognition, and started its evolution, during the mid 20<sup>th</sup> century. During its early stages, the call for corporate social responsibility was based on moral reasoning. However throughout the 1960s' and 1970s' there has been a shift in reasoning toward business rationales, realizing that social responsibility can lead to better financial performance. The scope and content of social responsibility has evolved into a wider construct since the 1980s to include increased emphasis on Corporate Citizenship, Human Rights, Environmental Responsibility, and Corporate Governance. Thus, this contemporary definition will serve further on in my thesis.

## **Chapter 3 The impact of Social Responsibility on Financial Performance**

### **Introduction**

This chapter investigates the relationship between corporate social responsibility and financial performance. This relationship is presented through models and theories that introduce the rationale for positive, negative and non-linear impacts that social responsibility might have on financial performance.

Although Corporate Social Responsibility initially started as an ethical stance, it has now become perceived as an element of business strategy (Lantos, 2002; Porter and Kramer, 2006). The idea that even self-interested economic pursuit by capitalists can lead to wealth to the wider society was recognized by Adam Smith during the 1770s, when he introduced the concept of 'the invisible hand'. Later on, after the concept of social responsibility had already been accepted, Davis (1960) was among the first authors to hint that CSR could lead to improved financial performance in the long-run. This was reflected by his definition of CSR as "decisions and actions taken for reasons at least partially beyond the firm's direct economic or technical interest" (1960:70). This idea was advanced later on by Johnson (1971) who was the first to propose, explicitly, a possible causation between CSR and financial performance. This appeared in the suggestion that "social responsibility states that business carry out social programs to add profits to their organization" (1971:54).

Since then, numerous authors have investigated the relationship between corporate social responsibility and financial performance (Griffin and Mahon, 1997; Orlitzky et al., 2003). Several models and theories have been proposed to explain the causation and direction of the relationship between CSR and CFP (Preston and O'Bannon, 1997; Margolis and Walsh, 2001). These approaches will be investigated and so provide the theoretical grounding for my research.

### **The Trade-off Hypothesis**

The trade-off hypothesis provides an explanation to negative impact of CSR on financial performance (Aupperle, Carroll, and Hatfield, 1985; Ullmann, 1985; McGuire et al., 1988; Preston and O'Bannon, 1997). Aupperle et al. (1985), the first to articulate this hypothesis, pointed out that socially responsive activities, such as charity, environmental protection, and community development, may draw off capital and other resources from the firm, thereby putting it at a relative disadvantage compared to firms that are less socially active. Hence, a firm's higher levels of social performance may lower its financial performance as compared to its competitors.

Other authors have elaborated on this phenomenon. McGuire et al. (1988) suggested that firms face a trade-off between social responsibility and financial performance. Accordingly, investment in social responsibility results in additional costs to companies who engage in such activities. Thus, the firms involved incur costs from socially responsible actions that put them at an economic disadvantage compared to other firms who may be viewed as 'less socially responsible' in their respective business contexts. Waddock and Graves (1997) further discussed such negative impact of social responsibility on financial performance. They describe an example of this kind of action by a firm that would decide to invest in pollution control equipment when other competitors do not. In such a case, the costs fall directly to the bottom line, reducing profits and thus shareholder wealth.

Preston and O'Bannon, (1997) made an association between the trade-off hypothesis and the earlier position of Friedman (1984) against corporate social responsibility. They suggested that social performance is the independent variable and that social accomplishments involve financial costs. These costs might reduce profit and cause decline in their stock prices relative to the market average.

McWilliams and Siegel (2001) went on to suggest that the costs associated with the creation of social responsibility can be conceptually equated to the costs of producing real products. They suggested that social responsibility actions can be viewed as social responsibility products. With this parallelism in mind they proceeded to outline a supply and demand model of CSR, and applied cost-benefit analysis for CSR.

Accordingly, should the costs of social-responsibility outputs be greater than the associated returns, then, they argued, profitability will decrease.

In contrast to the above explanation which focused on the financial burden of CSR expenditure, other scholars raised the issue of lack of association between such expenditures and returns. Ullmann (1985) claimed that it is not always simple, and sometimes might prove impossible, to identify the exact impact of CSR. He added that even if there is a change in revenues or profitability, it would prove grueling and impossible to measure or even correctly associate them with specific social responsibility practice (Ullmann, 1985).

Others have suggested that even if CSR might contribute to the profitability, it would prove difficult to associate such returns to the social expenditure (McWilliams and Siegel, 2000; Tsoutsoura, 2004). McWilliams and Siegel (2000) asserted that social responsible activities may lead to intangible attributes such as a reputation which might draw more customers, however hard to associate to the social responsibility expenditure. Similarly, Tsoutsoura (2004) noted that it is hard to associate socially responsible performance with specific bottom-line benefits, because many potential benefits of corporate social responsibility cannot be identified. For example, social responsibility can foster brand image and reputation, which in turn may draw more customers, as well as having increased ability to attract capital and trading partners. However it might prove impossible to associate specific returns directly with the costs of specific social responsibility actions. Thus, the causation mechanisms might be very complicated and not easy to track or identify (McWilliams and Siegel, 2000).

An additional reason for the seemingly negative relationship is the difficulty to associate social expenditure and possible returns on the same time frame, as there is a mismatch in their timing (McGuire et al., 1988; Orlitzky et al., 2003; Tsoutsoura, 2004). McGuire et al. (1988) suggested that the benefits of social responsibility, which may foster employee motivation and customer goodwill, may carry over into later periods. Therefore it should not be assumed that social responsibility can be associated with concurrent financial performance. Similarly, Tsoutsoura (2004) pointed out that in many cases the time frame of the costs and benefits can be out of

alignment. This situation is due to costs being immediate whilst benefits are not often realized until much later.

Others have suggested that the negative impact of social responsibility on financial performance might depend on the level of social expenditure (Balabanis et al., 1998; Barnea and Rubin, 2005). This phenomenon was reported by Balabanis et al. (1998) with regard to specific social responsibility expenditure. Accordingly, environmental care related activities – assumed to have a higher cost – were found to be negatively related to subsequent financial performance. On the other hand less costly CSR activities, like the enhancement of women's corporate position, were found to have a positive effect on the bottom line, although this was not always instantly realisable. Thus, there has been a constant search for levels of social expenditure that might be deemed either 'correct' or 'appropriate' for certain categories of businesses (McWilliams and Siegel, 2000).

Although a negative impact of high social responsibility on financial performance might seem an inevitable consequence of acts of good citizenship by the corporation, Barnea and Rubin (2005) suggested that it could simply be the result of self-interest by certain managers. They hypothesised that although increased CSR expenditure might have negative impact on financial performance, potential insiders including top executives and large blockholders, may prefer to over-invest in CSR for their private benefit. Their rationale for this strategy is that they believe it improves their reputation as being good global citizens. This hypothesis was confirmed in their empirical research. Barnea and Rubin (2005) explain that "A good social rating enhances their (i.e., executives) reputation as being decent individuals who respect their employees, communities and the environment and care about society. While insiders may benefit from CSR, other shareholders may not approve of a high CSR expenditure if it reduces firm value. Therefore, CSR may be the source of a conflict between different shareholders." (2005:2)

### **The Stakeholder Theory of the Firm**

The stakeholder theory of the firm is instrumental to the understanding the various models and theories, on the positive impact that social responsibility has on financial performance, that are discussed afterwards.

The stakeholder theory refers to the interaction between the company and various groups referred to as the stakeholders of the firm, and according to Freeman (1984:46) a stakeholder can be defined as “any group or individual who can affect or is affected by the achievement of the organization’s objectives.” This definition suggests that there is a bilateral relationship between the firm and its stakeholders, with both sides having a certain impact on the other. Similar definitions have been suggested by others (Clarkson, 1994, 1995), for example stakeholders are these who "bear some form of risk as a result of having invested some form of capital, human or financial, something of value, in the firm" (Clarkson, 1994:5), or "have a claim, ownership, rights, or interests in a corporation and its activities" (Clarkson, 1995:106). Because stakeholders are affected by the actions of the firm, they have a claim of involvement in those actions by the firm. Thus, these groups have stakes in the firm which accounts for the name 'stakeholders'. Stakeholders, or groups that can affect the firm or be affected by the firm, include employees, customers, suppliers, authorities, and the community (Jensen, 2002; Crane and Matten, 2004: 50-51; Preble, 2005).

Prior to the development of the stakeholder theory, the common concept was that companies should satisfy the need of their shareholders. The rationale is that because shareholders invest their money in the company, they are entitled to have financial returns. Thus, the company should consider their needs and operate in such a way that would maximise returns to shareholders. The stakeholder theory suggests that companies should consider the need of other stakeholder groups in their decisions and conduct, and thus look beyond profit maximization for shareholder only (Crane and Matten, 2004: 50-54).

The importance of the stakeholder theory comes from the understanding that these groups have the potential power to improve financial performance or otherwise lessen them (Donaldson and Preston, 1995). Thus, while the concept of corporate social responsibility has been largely philosophical, stakeholder theory is primarily a strategic management concept which aims to develop a competitive advantage through constructive relationships with its stakeholders (Freeman, 1984; Donaldson and Preston, 1995; Mitchell et al., 1997; Preble, 2005; Porter and Kramer, 2006).



Although there are various definitions of who are the stakeholder groups (Donaldson and Preston, 1995; Mitchell et al., 1997), the typical and important stakeholder groups represent those persons or aggregates of persons, who are directly and indirectly affected by the actions of a firm. This relationship is seen as a two-way link in which both sides have a recognized vested interest. Typical stakeholder groups are listed in Table 3-1 below, including examples of their interaction with the firm:

Stakeholder Group	Affected by the firm	Affect on the firm	Social responsibility issues
<i>Employees</i>	wage, social welfare, working conditions	Productivity, creativity, identification	health and safety, retirement benefits, union relations, cash profit sharing, employee involvement, workforce reductions
<i>Customers</i>	Product, Marketing, Customer Service	Purchase, Boycott	benefits the economically disadvantaged, quality and innovation, antitrust, marketing/contracting controversy, safety
<i>Suppliers</i>	Purchase, Contract terms	Price, Contract terms	misuse of power, gifts and bribes, unfair competition, honesty and integrity
<i>Community</i>	Jobs, Social Programs, Philanthropy	Impose limitations	charitable giving, innovative giving, non-us charitable giving, support for education, support for housing, volunteer programmes
<i>Shareholders</i>	Profit, Wealth, Risk	Available funds	compensation, ownership, political accountability, transparency, board of directors and management
<i>Government/Regulators</i>	GDP, Jobs, Taxes, Politics	Regulation, Taxes, Subsidiary	obey laws and regulation, misuse of influence/lobby, party financing, labour rights, employment of the disabled
<i>Environment</i>	Pollution, Preservation	Natural resources, Climate	beneficial products and services, clean energy, management systems, pollution prevention, recycling, agricultural chemicals, climate change, hazardous waste, ozone depleting chemicals, regulatory problems, substantial emissions

**Table 3-1 Typical Stakeholders and their interaction with the firm (After Crane and Matten, 2004)**

The need to prioritize stakeholder groups in order to make the interaction with them manageable has been pointed out by Mitchell et al. (1997) and later by Husted and

Allen (2001) and then more recently by Preble (2005). If managers have to take care of stakeholder dialog, and devise actions stemming from such interaction, they need to narrow them down (Mitchell et al., 1997; Preble, 2005). However, the definition of stakeholders as any group who affects or is affected by the firm may result in a large number of stakeholder groups. Thus, managers could have a difficult task of conducting a dialog with a large number of diverse stakeholder groups. Therefore, a method had to be devised for stakeholder identification and salience (Mitchell et al., 1997). Similarly, Husted and Allen (2001) pointed out that not all stakeholders can receive the same attention from firms because attention is a limited managerial and business resource that must be allocated efficiently. Thus, the firm's attention and response to a stakeholder depends largely on that stakeholder's salience.

Mitchell et al. (1997) suggested a model for Stakeholder Identification and Salience. They argued that stakeholders can be identified based upon the possession of the attributes of power, legitimacy, and urgency. Thus, their theory suggested that "Stakeholder salience will be positively related to the cumulative number of stakeholder attributes--power, legitimacy, and urgency--perceived by managers to be present" (1997:875). Stakeholder power was recognized to be the single most important attribute, which they defined as the inverse of the firm's dependence on the stakeholder. Accordingly, if all three attributes are present then the stakeholder group has high priority, while having only one attribute or none makes the group a low priority. This theory provided a tool for managers to identify 'who counts' among their potential stakeholder groups, and have a measure of salience among the groups (Mitchell et al., 1997).

The stakeholder theory of the firm has been said to have three aspects - descriptive, instrumental, and normative. Donaldson and Preston (1995), who presented these three aspects, asserted that while the descriptive and normative aspects tend to be theoretical plus explaining moral reasoning and characteristics of the relationship, the instrumental aspect is the one with practical use. The instrumental aspect assumes that corporations practicing stakeholder management will have superior financial performances as compared with their rivals. The instrumental stakeholder approach provides a framework for examining the relationship between the practice of stakeholder management and the achievement of corporate performance goals. Many

empirical studies on the relationship between CSR and financial performance made reference to instrumental stakeholder perspectives (Griffin and Mahon, 1997).

Thus, stakeholder theory provides an understanding of mechanisms that lead to a positive impact of social responsibility on financial performance. This positive impact of social activity on financial performance has been described by three theories from different view points. The *Stakeholder Management* model focused on the managerial aspect, the *Social Impact Hypothesis* focused on the social issues involved, and the *Resource-Based View* focused on the induced intangible assets, all leading to increase in financial performance.

### **Stakeholder Management**

The theory of the stakeholders of the firm (Freeman, 1984), which has become a central theme in CSR, suggested that there is a bi-directional interaction between the firm and its various stakeholder groups. The firm and the stakeholders can "affect or be affected" (1984:46) by each other. This means that various stakeholder groups, such as customers, employees, suppliers, local communities, governments, and shareholders can each in their respective ways affect the performance of the firm.

Thus, stemming from this definition is the recognition that managerial attention should be directed at these stakeholder groups, with the purpose of managing their influence of the firm – an activity referred to as 'Stakeholder Management' (Mitchell et al., 1997; Berman et al., 1999). This facet of stakeholder management, that aims to improve financial performance, has also been expressed as 'instrumental stakeholder management' by Donaldson and Preston (1995) who implied that it is used as a managerial instrument to improve a firm's achievement of their financial goals.

Donaldson and Preston (1995) suggest that through their interaction with the firm, stakeholders can have negative impact on the firm, as well as positive impact. Whether the stakeholders chose to support the firm or resist it, would depend on the way that the firm is perceived by the various stakeholder groups. This view was extended by Berman et al. (1999) who pointed out that stakeholders are now beginning to better understand how corporate behavior affects social, political, and natural environments. With this increase in understanding comes an increased

pressure from investors, consumers, and employees for companies to consider social and environmental criteria when making business decisions. Thus, stakeholders are concerned that any companies they support have business practices which positively impact society while achieving financial success.

Cornell and Shapiro (1987) asserted that should firms fail to identify, understand, and properly respond to the expectations of stakeholders they might face negative consequences from stakeholder actions. They further argued that firms can face the risk of expensive and time-consuming lawsuits, as well as lost investments. Given the increase in global business relationships and the threat of cross-country litigation, boards have to consider the risk management standards of business partners, and even suppliers. A decade later, with the increase in globalisation, Mitchell et al., (1997) argued that CSR also helps in compliance with regulation and the avoidance of legal sanctions, while the building of relationships with host governments, communities and other stakeholders can enhance a company's reputation and credibility and be of vital importance should it encounter difficulties in the future with regard to its investment decisions. Similarly, the relationship between the firm and its stakeholders can be built on positive grounds that will enhance the firm's performance (Tsoutsoura, 2004). Social responsibility actions addressing environmental and community issues, may encourage positive attitude of various stakeholder groups, and may result in increased financial performance.

Stakeholder management can have different levels of action. Carroll (1979) suggested four different levels of such action, as following (1979:501):

- Reaction: The Corporation denies any responsibility for social issues,
- Defence: The corporation admits responsibility but fights it, doing the very least that seems to be required.
- Accommodation: The Corporation accepts responsibility and does what it demanded of it by relevant groups
- Proaction: The Corporation seeks to go beyond industry norms and anticipates future expectations by doing more than is expected.

In the traditional view of the firm, management has to manage critical stakeholders including employees, customers and investors (Donaldson and Preston, 1995). This is achieved through specialized organizational functions managing core relationships including firm-employees, firm-customers, and firm-investors. In the extended enterprise view of Post, Preston and Sachs (2002), management has to deal with additional constituents as the principal means of sustaining and enhancing its wealth-creating capacity. Competence in managing stakeholder relations is therefore a source of competitive advantage of the firm.

A further and different viewpoint was suggested by Post, Preston and Sachs (2002) who viewed stakeholder management as managing the extended enterprise – a phrase which incorporates the firm and its stakeholder to a unified entity. Under this view the firm operates within a complex network of relationships with its various stakeholders. Managing this network of interrelated stakeholders can create and sustain an added value for the firm. Moreover, the long term survival of the firm and its ability to maintain market lead position is dependent on its ability to maintain effective relationships within the entire network of stakeholders.

Companies that practice stakeholder management, which include stakeholder identification and response to their expectations, can expect to see a positive impact on their financial performance. Ferrell et al. (2002: 237-253) provide examples of positive influence of proper stakeholder management, including:

- Influence over the cost of inputs and raw materials: Improvements in supply of materials and other inputs to the organization from improved synergy with suppliers. Suppliers, who can build long-term partnership with the companies they can trust, can improve their efficiencies which will result in lower cost of supplies;
- Better financial posture: Access to better financial conditions from investors, Socially Responsible Investment funds (SRI) and the market as a whole due to improved sustainability;
- Influence over the market/customers: Actions of social responsibility by corporations can provide for more customers with higher loyalty as a result

from better reputation built upon aspects such as product quality, environment friendly, and donations to the community;

- Improved interaction with authorities: Favorable attitude from legislators, regulatory agencies, and communities which can result in reduced expenses by the firm;

### **Social Impact Hypothesis**

Cornell and Shapiro (1987) argue that failure to meet the expectations of various non-shareowner constituencies will generate market fears, which, in turn, will increase a company's risk premium and ultimately result in higher costs and/or lost profit opportunities. Accordingly, the 'Social Impact' hypothesis (Preston and O'Bannon, 1997) follows the stakeholder theory in assuming that social responsibility actions, which meet the expectations of various stakeholders groups, will result in better financial performance. They suggested that serving the implicit claims of major stakeholders enhances a company's reputation in a way that has positive impact on its financial performance.

The social impact hypothesis is looking at the issue from the point of view of the social responsibility actions, as opposed to the stakeholder management which emphasizes the managerial process (Donaldson and Preston, 1995). However, in essence both models discuss the same phenomenon of positive impact that social responsible actions on the part of the firm, can create through the promotion of positive attitude within stakeholder groups, improved financial performance.

Several mechanisms of causation have been suggested for the positive social impact on financial performance, including (Ferrell et al., 2002: 237-253):

- *Employees:* Corporations with high CSR can attract better skilled employees, which will have high loyalty to the firm. Higher motivated employees can contribute to increased productivity as well as higher innovation capability, all of which can lead to positive impacts on financial performance.
- *Customers:* Firms investing in CSR can achieve product differentiation in the perception of the customers. With the increase of consumers who are sensitive to environmental and social issues, it can be expected that their purchasing

decisions will be affected by corporate behavior in these areas. Thus corporations can improve their market position and increase sales through CSR conduct.

- *Investors:* In general, corporations with high CSR can have better access to the financial markets. With the sharp increase in the trend of 'Socially Responsible Investment' (SRI), having good CSR ranking is critical to maximize the objective function of the firm.
- *Regulatory agencies:* Corporations that exhibit positively 'good' CSR can achieve improved conditions to operate on the part of the community, and local and governmental authorities. In the same way, if companies fail to meet environmental and social regulations and expectations, they can face increasing restrictions which can have a negative impact on their financial performance.

### **Resource-Based View**

The resource-based view (RBV) holds that firms possess resources, capabilities and competencies which enable them to achieve competitive advantage (Barney, 1991). Such competitive advantage can be sustained for a long period depending on the firm's ability to protect against resource imitation, transfer, or substitution (Barney, 1991; Peteraf, 1993). According to Barney (1991) resources can lead to sustainable competitive advantage to the extent that they are valuable, rare, imperfectly imitable and non-substitutable.

According to the RBV (Peteraf, 1993), these aspects have the following meaning: *Valuable* - when they enable a firm to implement strategies that improve its efficiency and effectiveness. *Rare* - implies that the valuable resources are not shared by large number of competitors. *Imperfectly Imitable* – the valuable resource can not be easily duplicated or imitated. *Non-Substitutable* – the competitors are not able to use or offer substitute. The term resource can include items such as assets, capabilities, organizational processes, firm attributes, information and knowledge.

The RBV of the firm offers an excellent theoretical perspective to explain how corporate social responsibility can lead to better financial performance, because it

explicitly recognizes the importance of intangible concepts, such as know-how (Teece, 1980), corporate culture (Barney, 1986), and reputation (Hall, 1992) in creating strategic competitive advantage. According to the resource-based view, resources are classified as tangible, intangible, and personnel-based (Grant, 1991). As far as intangible resources are concerned, they can include aspects such as reputation, technology, human resources and organizational culture. Husted and Allen (2001) suggested that these intangible resources can be affected by actions of social responsibility on the part of the firm.

The RBV of the firm has been widely used to provide explanation on how corporate social performance may affect financial performance (Husted and Allen, 2001). In contrast to the conceptual framework of the 'Stakeholder Management' and the 'Social Impact Hypothesis' that have emerged from the social responsibility domain, the RBV theoretical perspective comes from the business domain.

Human resources can be one example of how to build intangible competencies through the application of social responsibility actions (Greening and Turban, 2000; Orlitzky et al., 2003). Proactive human resources management can take many forms under social responsibility including training, safer working environments and social benefits. Moreover, other actions of social responsibility such as environment oriented actions can have impact on the human resources competencies. For example integration of new clean technologies adds to the complexity of the organizational process which will require increased skills from workers. Those increased skills, in turn, can contribute to improvement in productivity as well as effectiveness of the work force.

Another aspect of building intangible competencies through the application of social responsibility actions is corporate reputation (Russo and Fouts, 1997). According to this perspective actions of social responsibility may help build a positive image with stakeholder groups including customers, investors, and suppliers. Firms with higher CSP reputation may improve their access to capital; or attract better employees (Greening and Turban, 2000) or increase current employees' motivation, which in turn may improve financial performance (Waddock and Graves, 1997).



## Non-linear Relationship

Several authors have pointed out that the relationship between social and financial performance are not a simple monotonic plot, rising from left to right, but rather resemble an inverted U-shape curve (Bowman and Hire, 1975; Sturdivant and Ginter, 1977; Moore, 2001).

Bowman and Hire, (1975) set to find out what is the optimal level of social responsibility, asking and suggesting:

*"... how much is enough? The relationship between cost and benefit is difficult to determine, and it is not clear that the same relationship holds over the entire scale. Is more always better?" (1975:49).*

On the outset, Bowman and Hire, (1975) already noted that there are two opposing forces with regard to financial performance – the cost of being socially active and the benefits from it. They refer to the opposing forces:

*"... resources committed to such activities (i.e., social responsibility) come, net, out of the equity holder's pocket ..." and that it is difficult "... to measure the amount and worth of a firm's activities in the area of social responsibility. A detailed examination of what portion of an activity should be charged to responsible behavior and what, in any case, is the marginal cost and benefit of such activity is hard to find." (1975:49).*

In their research Bowman and Hire, (1975) found that the relationship between social responsibility and financial performance resembled an inverted U-shaped curve. Thus, they explain that:

*"Medium activity in corporate responsibility is clearly more closely associated with high profitability than is either little or much activity" (1975:52).*

They re-analyzed data from their previous research (1972) and found again an inverted U-shape curve. Once more the curve appears asymmetrical - the left tail is lower than the right. In summary, Bowman and Hire (1975:54) argued that:

*"... more is not monotonically better than less; rather, there is a U-shaped relationship in which some is better (in terms of association with profits) than little or none and that still more tends to be associated with less return than the middle ground."*

Similarly, Sturdivant and Ginter (1977) found also that financial performances are related to social responsibility in an inverted U-shape curve. Accordingly they too took the position that more social responsibility will not necessarily lead to improved financial performance, stating:

*"While the findings certainly will not support the argument that socially responsive companies will always outperform less responsive firms in the long run ... " (1977:38).*

These findings by Bowman and Hire (1975) and Sturdivant and Ginter (1977) were restated by Ullmann (1985), on the basis of his review of findings by previous research. He noted that overall those finding from multiple previous research were ambiguous, as well as pointing again to the U-shaped correlation found by Bowman and Hire (1975).

Based on those previous finding of U-shaped correlation Moore (2001) called for the need of non-linear model that will rectify the drawback of the negative and positive impact theories which explained only linear – negative or positive, relationship. One model was suggested by McWilliams and Siegel (2001), which was based on supply and demand theory. They argued that firms produce social performance outputs that will be in equilibrium with the demand by stakeholders, to arrive at profit maximizing level.

### **The Unified Theory**

The unified theory (Marom, 2006) can explain a non-linear relationship between CSR and CFP, including positive and negative segments. The unified theory (Marom, 2006) of the relationship between corporate social performance (CSP) and corporate financial performance (CFP) provides a framework for rationalizing the inverted U-shape correlation between social responsibility and financial performance. In this way it builds upon the theories of Bowman and Hire (1975) and by Sturdivant and Ginter (1977).

The unified theory considers Social Outputs to be Social Products as suggested by Murray and Montanari (1986) who put forward the idea that the social outputs of the

firm be considered *social products*. The major tenet of this approach is that CSR can be analyzed as a source of 'products', which are offered implicitly by the firm to its various stakeholders. These social products address the needs and expectations of various stakeholder constituencies (Donaldson and Preston, 1995). It has been asserted that this is what stakeholder management is about (Rowley and Berman, 2000). From the CSR perspective, it is claimed that social products are specific outputs aimed at satisfying a demand of stakeholder groups for social responsibility (McWilliams and Siegel, 2001). Thus, stakeholders can be regarded as a type of consumer, benefiting from the social products produced by firms. Social products are therefore the medium of an exchange process between the firm and its stakeholders.

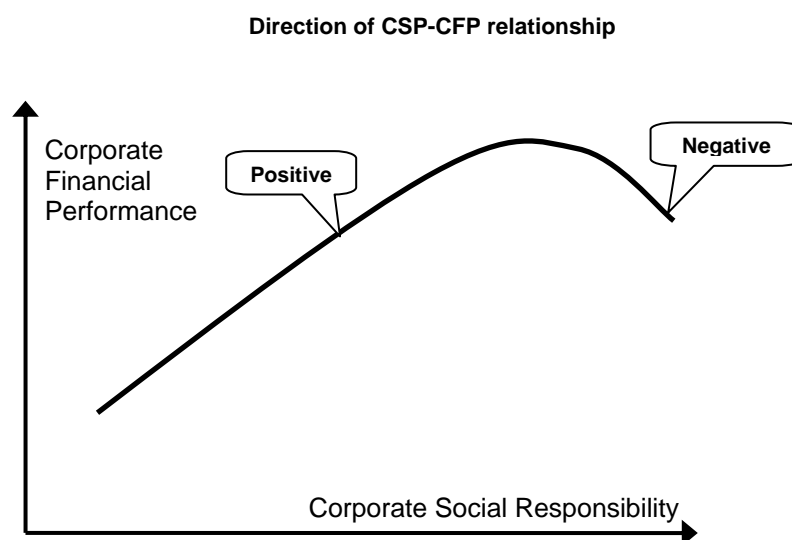
However, in creating social responsibility outputs or 'products', the firm has to invest various resources which are regarded as expenditure costs (Vance, 1975; McGuire et al., 1988; Barnea and Rubin, 2005). On the other hand, social responsibility which is intended to satisfy the expectations of stakeholders, will be rewarded with various benefits contributing to the bottom line (Donaldson and Preston, 1995; Mitchell et al., 1997; Berman et al., 1999; Preble, 2005). With benefits from social responsibility on one hand, and their costs on the other hand, a cost-benefit analysis can be used to investigate results (McWilliams and Siegel, 2001). They outlined a supply and demand model of CSR, and applied cost-benefit analysis for CSR. They also suggested that firms produce at a profit-maximizing level, including the production of both core-products and social responsibility outputs. The social outputs produced depend upon on the unique demands for CSP that the firms experience. At optimum production levels, the amount of CSR produced by firms will maximize their profitability.

Thus, the unified theory (Marom, 2006) regards *Social Outputs* to be *Social Products*, and *Stakeholders* as the equivalent to consumers. It considers both the *Cost of Social Outputs* and the *rewards* or dividends earned by the firm from satisfied stakeholders. Since it addresses both rewards and costs, the unified theory puts together the two previous hypotheses about the CSP-CFR relationship – the social impact hypothesis, and the trade-off hypothesis. While the first hypothesis emphasized the increase in firms' financial performance due to its meeting stakeholders' needs, the later

emphasized the costs of producing social outputs, which consequently reduce profitability.

Having considered the two opposing forces – CSR-related rewards and costs – the unified theory explains all possible relationships between CSP and CFP. Depending upon whether marginal rewards are more or less than marginal costs, the relationship can either be positive, negative or neutral. This phenomenon of decreased marginal utility has been suggested by Barnea and Rubin (2005). In its general form the unified theory comprises  $M \times N$  components, where 'M' number stakeholders face 'N' number of social outputs. With that many elements the relationship could prove to be quite complex, and certainly could oscillate between positive and negative values.

The advantage of the unified theory over previous models is that it allows for a non-linear relationship between CSP and CFP. As presented earlier in this chapter, several authors (Bowman and Hire, 1975; Sturdivant and Ginter, 1977) have reported an inverted U-shaped relationship between CSP and CFP. The contradicting influence of the cost and benefits of CSP can cause a positive relationship at certain levels of CSP, which turns to negative relationship at high levels of CSP. This tendency toward an inverted-U relationship is illustrated in Figure 3-1, having both positive and negative segments of the CSP-to-CFP relationship.



**Figure 3-1 A conceptual inverted-U relationship between CSP and CFP**

## **Chapter Summary**

This chapter has discussed the models and theories which imply that corporate social performance (CSP) has an impact on corporate financial performance (CFP). Accordingly, actions of social responsibility have both negative and positive impact on financial performance. Negative impact results from the fact that the "resources committed to such activities come out of the equity holder's pocket" (Bowman and Hire, 1975:49); while a positive impact comes from the actions of satisfied stakeholders (Mitchell et al., 1997). Thus, there would be an optimum level of social responsibility for financial maximization (McWilliams and Siegel, 2001). The 'Unified Theory' (Marom, 2006) provides the theoretical formulation of such cost-benefit analysis, suggesting a non-linear relationship which resembles an inverted U-shaped function.

Next, I will further explore the literature regarding the issue of the relationship between social responsibility and financial performance, by investigating past empirical research. Understanding of issues raised by past research will further the understanding which will serve for the design of my research.

## **Chapter 4 Extant Studies**

### **Introduction**

Past research on the issue of the relationship between corporate social and financial performance provides insights that can contribute to my research. Thus, this chapter provides a thorough investigation of the extensive and extant past research in this field.

This investigation will focus on three major issues arising in past research (Griffin and Mahon, 1997; Margolis and Walsh, 2001). First, the variability in their theoretical perspective and research design (Griffin and Mahon, 1997; Orlitzky et al., 2003). Second, the differences in operationalisation and measurement of the variables (Griffin and Mahon, 1997; Margolis and Walsh, 2001). This refers to the concept of social responsibility as well as the concept of financial performance. Thirdly, the inconsistency in results and conclusions about the relationship between CSP and CFP (Griffin and Mahon, 1997; Margolis and Walsh, 2001; Orlitzky et al., 2003). These issues are central to designing my research and therefore are dealt in-depth in this chapter.

### **Theoretical Perspective**

The main variance in past research has been their different theoretical perspective, which has also reflected on their methodology (Griffin and Mahon, 1997). Research perspectives differ in their viewpoints with respect to inquiry space in terms of nature of the social issues, the type of industry in question, time coverage, causation sequence and locations. This section will explore the variety in theoretical perspective to draw upon such understanding for the design of my research.

#### *Social and/or Environmental perspective*

One difference in research approach was the scope of social responsibility. Several studies focused on the environmental impact of firms' operation (Shane and Spicer, 1983; Russo and Fouts, 1997; Orlitzky et al., 2003). This kind of approach tended also to focus on the firms' reputation as a mediating factor between their environmental

responsibility and financial performance. This approach followed the hypothesis that companies who are perceived by the public as non environment friendly might face customers' buyouts resulting in reduced financial performance (Russo and Fouts, 1997; Orlitzky et al., 2003).

However, most of the research on the issue of the relationship between social responsibility and financial performance took a wider approach with regard to social responsibility (Orlitzky et al., 2003). Such type of research has normally probed several dimensions of social responsibility, with the environment responsibility as a possible additional dimension of social responsibility (Griffin and Mahon, 1997). Thus, accepting the wide definition of social responsibility, as presented in chapter 2, should result in theoretical perspective that considers the dimensions of social responsibility, and not be confined to the environment responsibility only (Griffin and Mahon, 1997; Margolis and Walsh, 2001).

#### *Single Industry and Cross Industry Scope*

A dilemma for researchers has been whether to choose a single or multiple industry research design for their study. Some authors (Wokutch and Spencer, 1987; Griffin and Mahon, 1997) advocated a research design that focused on a single industry, substantiating their recommendation on the understanding that various industry sectors have different attributes and characteristics which can not be compared adequately within a single study.

Wokutch and Spencer (1987: 74) recommended that "future research on this topic (CSP/CFP) needs to be conducted within specific industries". Various industry sectors have different attributes and uniqueness in their internal competencies and external pressures that create a 'specialization' of social interests. Similarly, Griffin and Mahon (1997), whose research was based on a single industry perspective, suggested that future research will be focused on a single industry due to the different nature in social responsibility between different industry sectors. Thus, most of the studies focused on cross-sectional industries, rather than on a single sector (Orlitzky et al., 2001).

### *Sample Size*

Sample size has been closely related to the selection of industry coverage - single or multiple. Single industry research approach tended to have a relatively small sample size with no more than ten to twenty companies. This sample size of single-industry research was attributed to two main reasons. First, the selection of single industry has resulted in fewer available companies compatible with the research requirements.

Second, single industry research offered the opportunity to have a more in-depth investigation and comparison between the companies, base on their similarities. The internal consistency within the same industry sector enabled detailed investigation and comparison; which called for a limited number of sampled companies. Thus, the efforts invested in in-depth investigations have resulted in deliberately narrowing the sample size to make the research manageable. Such a detailed investigation was not possible in a cross-industry research design which included companies from different sectors, having inherent differences in their attributes.

The match between single-industry and sample size is reflected in single-industry empirical research. The Griffin and Mahon (1997) research was based on a single industry perspective, which investigated companies from the chemical industry in the USA. Aiming for a thorough investigation of that industry, their sample size was limited to seven companies. Similarly, the Moore (2001) research referred to a single industry, namely, the supermarket industry in the UK. His research also spanned over a small sample size of eight companies, which enabled a thorough investigation and comparison of their various attributes.

An exemption in the size of a single-industry research was the research by Simpson and Kohers (2002). Their research investigated a single industry - the banking industry in the UK. However their sample size was relatively large and included 385 institutions. With that large sample size, Simpson and Kohers had to settle for a limited number of attributes concerning the performance of each company, and their comparison thereof.

In contrast, many studies that adopted a cross-industry perspective, in which the research investigated companies from multiple industry sectors, used a large sample



size. For example, Waddock and Graves (1997) investigated the relationship between CSP and CFP for companies in the US, belonging to multiple industry sectors, with a sample size of 469 companies. Similarly, Verschoor (1998) conducted his study with reference to companies from multiple industry sectors, with sample size of 376 companies in the US. Yet, another example was the research by Verschoor (2002) which was a cross industry investigation over a sample of 100 companies.

The correlation between sample size and the selection of a single or multiple industries is shown in Table 4-1, which brings some examples from past research, with the full details shown in Appendix 4.1

Research	Cross/Single industry	Sample size	CSP-CFP correlation
Griffin and Mahon (1997)	Single	7	Inconclusive
Waddock and Graves (1997)	Multiple	469	Positive
Preston and O'Bannon (1997)	Multiple	67	Positive
Verschoor (1998)	Multiple	376	Positive
Moore (2001)	Single	8	Inconclusive
Simpson and Kohers (2002)	Single	385	Positive
Verschoor (2002)	Multiple	100	Positive
Webley and More (2003)	Multiple	24	Positive

**Table 4-1 Cross/Single Industry and Sample size**

The above table reveals another understanding – cross-industry, large sample size research tended to be more conclusive in their reported results. This phenomenon can be attributed to a mediating factor which is sample size. Single industry studies were compelled to use small sample size, which led to lower significance of correlation. Whilst, cross industry studies were able to use large sample of companies, which in turn contributed to higher significance and stronger correlation (Orlitzky et al., 2001).

Thus, although some authors (Griffin and Mahon, 1997; Moore, 2001) recommended a single-industry research focus based on the internal similarities between sample items, others preferred having a large sample size using a cross-industry research approach (Turban and Greening, 1997; Waddock and Graves, 1997).

### *Various Causation Sequence*

Whether corporate social responsibility has an impact on financial performance has been the focus of many studies in the past, however, others had different theoretical perspectives in that they were striving to find the answer to the 'egg and chicken' question – i.e., what is the causation sequence between social responsibility and financial performance. This research design sought to find out which hypothesis is correct – does social responsibility influence financial performance, or vice versa (Preston and O'Bannon, 1997; Moore, 2001).

Such a theoretical perspective of research had to be followed by a design that would allow for testing of the direction of the relationship, and searching for the causation sequence between social responsibility and financial performance. The most widely used tool was a research design that was based on time difference between the measuring of the two variables, as explained in the following section.

### *Temporal Sequence / Timing (Concurrent, Market Value/Future)*

Studies varied in their design of time span, and more specifically in their temporal sequence for two main reasons (Orlitzky, 2003). First, some authors assume that there is a time difference between the effects of social responsibility on financial performance (Moore, 2001). This led to a design that looked at social responsibility during one period, and investigated the resulting financial performance during the next period. The next period would normally refer to the subsequent one or two years after social responsibility had been measured (Moore, 2001).

Second, studies that investigated the direction of causation between social and financial responsibility (as previously explained), accomplished that through adopting a lead-leg design over time (Preston and O'Bannon, 1997; Moore, 2001). This design is based on the hypothesis of time separation between cause and result, which will allow for distinction 'who comes first' between social or financial performance (Ullmann 1985; McGuire et al. 1988; Waddock and Graves 1997). Thus, various temporal associations were tested, including: (a) prior CSP related to subsequent CFP; (b) prior CFP related to subsequent CSP; and (c) contemporaneous (cross-sectional) associations.

However, this research design is unique to such studies that aimed to find out the direction of causation, and would not fit the current research aim and design.

### *Location*

Most of the empirical research on the issue of relationship between corporate social and financial performance has been done in the U.S.A. and U.K. (Orlitzky, 2003). This has been attributed to two main reasons. First, the leading position of those locations within the business world and global economy; including transparency of corporations' data as well as established practices for social ranking, made such research possible. Second, the leading position of the academy's interest in corporate social responsibility, resided mainly in those locations. However, there have been also a small number of studies conducted in other locations, where social responsibility awareness existed, and social responsibility data had become available. The availability of social responsibility data is a critical enablers for such research, thus its availability has been a main reason to the absence of such research or the emergence of such research in recent years. This is also the case with regard to my research in Israel, as will be presented later on in chapter 5.

### *Methodology*

Past empirical research on the relationship between corporate social and financial performance shows that most of them have been deductive. The deductive approach assumed a hypothesis about the said relationship – either positive or negative, and sought to verify the hypothesis through testing of a sample of corporations. The inductive approach tested a sample of companies to find out specific patterns of association between social and financial performance, to come up with a suggested theory based on the finding – i.e., negative, positive or no relationship. Thus, deductive approaches tested theory, and inductive approaches developed theory.

Some studies adopted a case study approach, with in-depth exploration of few cases. Such exploration considered extended information about each case, beyond just the social rating and financial performance. Additional exploration included interviews with managers, employees, and other stakeholder groups, leading to additional, finer grain findings. For example, Moore (2001) investigated the relationship between social and financial performance for the U.K. supermarket industry. His investigation

covered only eight firms. However, this enabled him to extend his research over a longer period, trying to identify trends over time. In addition, he was able to conduct personal interviews with several managers from each company, allowing for a more thorough understanding of drivers affecting the extended relationship. The case study provided a comprehensive understanding of the decisions, processes and mechanisms that led to a certain relationship between social and financial performance. However, a drawback of having fewer cases is its low statistical significance due to the small sample size. Therefore, aiming to have a high statistical significance, most of the studies in the field of the CSP-to-CFP relationship, have used multiple cases rather than single case studies (Griffin and Mahon, 1997; Orlitzky et al., 2003).

### **Operationalisation and Measurement of CSR**

This section will explore the theoretical perspective underpinning the operationalisation and measurement of corporate social performance (CSR). It will review the various measures of social performance that have been used, and the considerations in adopting a certain practice. This understanding will be used later on in adopting a certain practice for my research.

The measurement of the social performance of a firm has been widely discussed and debated (Griffin and Mahon, 1997; Margolis and Walsh, 2001; Orlitzky et al., 2003). This was due to the complexity of measuring the social performance of corporations, and the fact that flaws have been pointed out in each methodology, that masked the true value of the social variables (Griffin and Mahon, 1997; Rowley and Berman, 2000; Margolis and Walsh, 2001). The difficulty in deciding upon a measure of social responsibility is mostly due to three reasons that are inherent to the concept. First, the concept of CSP is very vague in itself. Secondly, in trying to operationalise the concept, researchers come up with variety of constructs for CSP. Constructs themselves differ in their definitions and dimensions. Moreover, it remains questionable whether aggregation across all the dimensions provides a viable measure for CSP. Thirdly, there is no clear universal gauge to measure social responsibility along its various dimensions.

As a result of above difficulties, past research has been reported by reviewers (Griffin and Mahon, 1997; Margolis and Walsh, 2001) to have many different measures of

social responsibility. The variance in measures can be attributed to two main reasons. First, there has been a conceptual difference in the source of data which served to establish the level of social responsibility (Margolis and Walsh, 2001). Whether the source of information was self-reported by the companies, or provided through independent external evaluation, could result in different outcomes as discussed below. Second, the construction of a single weighted index for social performance was methodically questionable (Rowley and Berman, 2000; Margolis and Walsh, 2001). For example, it is debatable whether such weighted index which was aggregated along different dimensions for different industries can be compared (Rowley and Berman, 2000). Those two issues are investigated below. With regard to the first issue, of data sources for measuring social responsibility, four practices existed (Margolis and Walsh, 2001):

- Corporate Disclosure-Based data:
  1. Qualitative text-based reports
  2. Quantitative numerical-based reports
- External Evaluation:
  3. Survey-Based Subjective Measures
  4. Evaluation-Based Measures

These methods are investigated in the next section.

### **Corporate Disclosure-Based Behavioral Measures of CSP**

Aiming to overcome the ambiguity and inaccuracy of the survey-based subjective measures, some researchers (Bowman and Haire, 1975; Abbott and Monsen, 1979; Cowen et al., 1987; Davidson and Worell, 1990; Verschoor, 1998) turned to use behavioral measures that are based on official information disclosed by the companies themselves. Most widely used were various kinds of official information that companies are obliged to disclose under law and regulations. Among such official disclosures are annual reports to shareholders, and the 10Ks reports that companies publish in accordance with the Securities and Exchange Commission (SEC) regulations. Other corporate disclosure sources have been used as well such as the Toxics Release Inventory (TRI) report – a mandatory report applicable to the chemical industry in the U.S., corporate philanthropy report, and official internet sites.

An annual report is a document which a company presents at its Annual General Meeting for approval by its shareholders. The report is made up of several parts and of financial statements. First, it provides an overall outlook through the chairman's and CEO's reports, as well as strategic orientation. Then, the annual report includes a financial section which provides elaborated financial information including balance sheet and statement of profit and loss. In addition, it provides support information such as corporate governance and auditor's report and is therefore regarded as a reliable source on the financial and trading state of the corporation. In the United States, a more-detailed version of the report, called a Form 10-K, is submitted to the U.S. Securities and Exchange Commission. In addition to the information provided by an annual report, the 10-K includes information such as company history, organizational structure and data on executive compensation. Such additional data can support a more informed evaluation of the firm's CSR. Two distinctive types of disclosure data have been used – numerical based quantitative data, and descriptive based qualitative data, which are now discussed.

### **Qualitative Text-based Reports**

Qualitative extraction of CSP rating from corporate disclosed resources is based on content analyses (Margolis and Walsh, 2001). Such context analysis can consider different types of information within the official communication of the firm. However, there is the question of whether one can rely on self-reported information as a valid source for measuring CSP.

Some studies that tested the correlation between social disclosure in the official reports of the firms and their actual social performance concluded that there was little correspondence between the two (Wiseman, 1982; Ullmann, 1985). Ullmann (1985) portrayed the negative point of view on the issue and has concluded that management has reasons to either underreport or overstate their social disclosure.

Managers' view that social disclosure is a public relations action which should serve for portraying positive image, is the reason for overstating social responsibility. In contrast, the reason for under-reporting is due to the fact that managers try to minimize the attention to the costs associated with activities of social responsibility from the shareholders. As such, costs may reduce profits and thus come at the expense

of those shareholders (Ullmann, 1985). Thus, Ullmann's conclusion was that one should not rely on information provided by the firms for evaluating its social responsibility.

A similar conclusion arose in a completely different, yet modern, research paradigm by Esrock and Leichty (1998). In their study they conducted an extended content analysis of the web pages of some 100 companies from the list of *Fortune* 500. For each web site they looked for the presence or absence of messages relating to 13 social responsibility content areas. The results confirmed that information disclosed through web pages was very much part of image building rather than an indicator as to the level of social responsibility. Moreover, their research confirmed that large companies, apparently with more available resources, did more to communicate social responsibility than their smaller counterparts. Yet an additional similar conclusion was reported by Margolis and Walsh (2001), based on their investigation, stating: "there is no way to determine if the social performance data revealed by corporations are under-reported or over-reported" (2001:18).

In contrast, positive correlation was reported by Verschoor (1998) who conducted a context analysis of company annual reports, by focusing on the parts which provided management statements on internal control, and found a positive correlation between the length of the report and the width of scope of subjects it covered, and the social performance of the firm. Although a finding of positive correlation was reported by Verschoor most of the studies suggested that self-reported information by firms regarding their social responsibility, are not a valid source for measuring the nature of CSP.

### **Quantitative Numerical-based Reports**

Quantitative extraction of CSP rating from corporate disclosed resources is based on numerical data within the reports. Such data could include information regarding resource allocation to social responsibility activities, or other similar parameters. Some studies that provided a comprehensive overview of past research (Griffin and Mahon, 1997; Margolis and Walsh, 2001) reported that in most cases where numerical disclosure social responsibility data was used, it related to environmental issues and philanthropic contributions.

With regard to environmental issues, the most dominant example has been the Toxics Release Inventory –TRI (Griffin and Mahon, 1997). This index was used by governmental agencies, such as U.S. Environmental Protection Agency, to monitor relative amounts of discharges into the environment. It consists of self-reported information on environmental discharges to the water, air, and landfills, and disposal of hazardous waste. The TRI collects information about chemical releases and waste management reported by major industrial facilities in the U.S. The TRI database was established by Section 313 of the Emergency Planning and Community Right-To-Know Act of 1986. Under EPCRA, industrial facilities in specific sectors are required to report their environmental releases and waste management practices annually to the Environmental Protection Agency. Accordingly, covered facilities must disclose their releases of approximately 650 toxic chemicals to air, water, and land, as well as the quantities of chemicals they recycle, treat, burn, or otherwise dispose of on-site and off-site (U.S. Environmental Protection Agency). In the U.S., TRI data derived from thousands of industrial facilities, is published on the web site of the Environmental Protection Agency, thus, making it available for research on the environmental dimension of corporate social responsibility (Griffin and Mahon, 1997).

Although easily available in the U.S. TRI data has critical limitations as well. TRI may significantly underreport releases, because companies use unreliable emissions factors to estimate their releases, rather than monitor their actual emissions. Moreover, TRI does not cover all toxic chemicals that have the potential to adversely affect human health or the environment (Griffin and Mahon, 1997).

The issue of community oriented social responsibility has provided the other commonly used quantitative-base behavioral measures of CSP - corporate philanthropy reporting. This data on philanthropic contribution is provided by leading companies in exact dollar amount. Moreover, there have been several public directories that published ranking of the companies according to their philanthropic giving, such as the Corporate 500 Directory of Corporate Philanthropy, which make this data ready for use by researchers.

Although the use of numerical data for rating CSP seems very accurate method, some have suggested that the opposite is true (Margolis and Walsh, 2001). The core of the



problem lies mainly with the fact that companies use such publication to improve their image, while at the same time their negative impact on society is concealed. An example of this problem can be seen in the case of Philip Morris (1999) the cigarette manufacturer. While the company social disclosure reported charitable activities of \$75 million per year, which promoted positive social image, it had also spent \$100 million promoting sales of cigarettes, which cause health problems in society. This reiterates again that self-disclosure social responsibility data, even if it comes in a smilingly accurate numerical form, can not be taken as a reliable measure for social responsibility (Margolis and Walsh, 2001). In summary, the validity of relying on corporate disclosure of qualitative and quantitative data to estimate the level of CSP has proven to be low (Griffin and Mahon, 1997; Margolis and Walsh, 2001).

### **External Evaluation-based Measures of CSP**

The alternative to gauging social responsibility based on the companies' self reported data is having an external independent evaluation of the corporate social responsibility. These include two practices: Survey-Based Subjective Measures, and Evaluation-Based Measures which are discussed in this section.

#### *Survey-Based Subjective Measures of CSP*

Subjective measures of corporate social performance, as implied by the name, have relied on polls and surveys that gathered information from those regarded 'informed observers' (Margolis and Walsh, 2001). This method of obtaining a measurement of CSP has developed during the early years of research on the relationship between CSP and CFP. During that time no other methods of measuring CSP existed, and thus researchers turned to surveys (Moskowitz, 1975). Accordingly, CSP ranking has been obtained through surveys among various populations that have been regarded knowledgeable with regard to the business environment of corporations. Surveys turned to executives of companies as well as to students of business schools, based on the assumption that those groups have the knowledge and ability to assess the level of CSP of corporations (Vance, 1975; Heinze, 1976; Sturdivant and Ginter, 1977; Alexander and Buchholz, 1978; Cochran and Wood, 1984).

Some studies (Moskowitz, 1975; Vance, 1975; Sturdivant and Ginter, 1977; Cochran and Wood, 1984) used a single survey which obtained data from one group type. Such

was the research by Sturdivant and Ginter (1977). Their study involved a survey of company managers seeking for their evaluation on the level of CSP exhibited by other companies. A slightly different approach was used by others who triangulated data obtained from more than one group type (Vance, 1975; Alexander and Buchholz, 1978). For example, the study by Alexander and Buchholz (1978) probed separately businessman and business students who were asked to rate leading firms in the US on their perceived degree of social responsibility.

Using surveys, as a tool for identifying the level of social responsibility, has its advantages and disadvantages (Cochran and Wood, 1984; Margolis and Walsh, 2001). On the advantage side, three reasons are mentioned. First, surveys are consistent as far as one evaluator is concerned because such an observer will apply the same subjective criteria for all the rated companies. Second, subjective surveys do not pretend to be objective, which is compatible with the subjective nature of CSP in the first place. Third, addressing various audiences, surveys may inherently represent the perception of several constituencies. As far as disadvantage is concerned, Cochran and Wood (1984) maintain that it is the obvious fact that survey-based rankings are highly subjective.

The surveys that have been used by the largest number of studies (Spencer and Taylor, 1987; Wokutch and Spencer, 1987; McGuire et al., 1988; Margolis and Walsh, 2001), on the issue of the relationship between CSP and CFP, have been the 'business school students' survey and the *Fortune* survey. The 'business school students' survey was the earlier between the two, and was used more frequently during the decades of the 1970s and 1980s. The survey was usually conducted among 300 graduate students of business administration who were asked about their views on the social responsibility of specific *Fortune* 500 firms. The later *Fortune* survey, which is still in use by contemporary studies on the issue, is a more advanced tool than the 'business school students' survey in that it is multi-dimensional. A description of this tool is provided next.

#### The *Fortune* Survey

The *Fortune* survey, published annually by *Fortune's* magazine since 1983, is named the 'most admired U.S. corporations'. Companies surveyed belong to more than 30

different industry sectors in the US. The ranking of the companies is based upon eight attributes, including quality of management, quality of products or services, value as a long-term investment, innovativeness, soundness of financial position, ability to attract, develop, and keep talented people, responsibility to the community and environment and wise use of corporate assets. The scale used for ranking is between zero (poor performance) to ten (excellent performance), and results are aggregated to determine an overall ranking of corporate reputation (Fortune's magazine).

The Fortune 500 survey, in contrast to the previously administrated 'business school students' survey, has higher trust and reliability due to several unique features. First, the survey had a sample size of several thousands of respondents. Second, the respondent population was based on executives, managers and experts belonging to different industry sectors, who were more knowledgeable on these matters in comparison to students. Third, the alteration in the respondent population over the years was more moderate in comparison to the prominent changes in the student population. These unique features of the Fortune survey made it more reliable in comparison to previous surveys (Chen, Fahr, and MacMillan, 1993).

The main disadvantage of the Fortune survey has been that several of the eight attributes were measures of financial performance; including value as a long-term investment, soundness of financial position, and wise use of corporate assets (Griffin and Mahon, 1997; Margolis and Walsh, 2001). This means that the Fortune ranking of CSP actually reflects a firm's financial performance (Brown and Perry, 1994). Thus, when used in a research on the correlation of CSP to CFP, the independent variable and the dependent variable are partially drawn from the same data source, which could be the main reason that correlation exists. Moreover, the financial performance part of the survey created a 'halo effect' which influenced the other attributes to follow its direction (Brown and Perry, 1994). According to Brown and Perry (1994), the financial performance have influence the perception of the observers creating a high reputation for the firm qualities. This perception went on to influence the subjective evaluation of the observers as to the level of the other attributes in the survey. The influence of financial performance is understandable, recalling that executives and industry analysts are very interested in financial performance.

The limitation of the Fortune survey is evident from the fact that all the eight individual attributes of corporate reputation rated in the Fortune survey have been shown to be highly correlated. Fombrun and Shanley (1990) used factor analysis on the eight variables and extracted one factor that explained 84 percent of the variance. They concluded "that the eight attributes elicited from respondents were components of an underlying and stable construct of reputation" (Fombrun and Shanley, 1990: 245). The high correlation that exists between the overall reputation ranking and the individual attribute suggests that the overall subjective perception of a company may be the dominating factor in determining the relative ranking of its social performance within the Fortune survey (Fryxell and Wang, 1994). Thus, subjective survey-based measures of social responsibility encompass apparently significant flaws, and do not represent a reliable measuring tool (Fombrun and Shanley, 1990; Brown and Perry, 1994; Fryxell and Wang, 1994).

#### *External Evaluation-Based Measure of Social Performance*

With the many limitations of the previously reviewed measures, scholars turn to find a different approach which will overcome drawbacks and provide a robust measure of social responsibility. Social ranking has become increasingly more important than just a matter for research purposes, but rather an important driver of the business world with multi-billion worth of investment funds seeking to reduce risk and improve yield through socially responsible investment (SRI) strategy. SRI assumes that the socially responsible firms are less prone to risks posed by their operating environment, and have increased potential for sustainable returns, thus representing preferable investment over other firms.

The growing importance of social ranking, and the vast financial resources allocated from the business world, saw the emergence of firms whose business was the task of social ranking in itself (Porter and Kramer, 2006). This meant that considerable resources were made available for the task of gauging social responsibility, allowing for an elaborate and thorough process of measurement.

Those two drivers, the need for a better social ranking system together with the available funds, created the 'External Evaluation-Based Measure of Social Performance'. This measurement system of social performance is based on two

principles: Firstly, external evaluation of CSR along the dimensions of the stakeholder theory, and Secondly, integration of multiple gauging techniques, including partial use of data obtained through the use of the previous measurement systems. Those principles are explained below.

The first principle suggested that the measuring of corporate social responsibility should consider all the stakeholders of the firm. Scholars used also the notion of dimensions to denote the various stakeholder groups, thus calling for a multi-dimensional measurement of social responsibility. The logic for this approach was drawing on the 'Stakeholder Theory of the Firm' (Freeman, 1984). As all stakeholder groups can affect or be affected by the firm, the firm which calculates social responsibility should consider its responsibility toward all the stakeholders. Thus, measurement is done by tracing social responsibility activities as they bear on each category of the primary stakeholder groups.

This represented a systematic approach calling to measure social responsibility that targets all stakeholders, as opposed to past research which in many cases used a measure of social responsibility that targeted only one or few stakeholders. For example, some studies (Freedman and Jaggi, 1982; Newgren et al., 1985; Russo and Fouts, 1997) measured environmental aspects of social responsibility, while other studies (Alexander and Buchholz, 1978; Cochran and Wood, 1984; Simpson and Kohers, 2002) measured social responsibility along the dimension of the customer stakeholder group. The new stakeholder approach has provided a detailed framework as to what has to be looked for and measured within the social responsibility practice of the firm (Clarkson, 1995; Wood and Jones, 1995). The various dimensions of CSP have to be measured in alignment with the various stakeholders groups of the firm, including shareholders, customers, employees, suppliers, regulators, the community, and the environment.

The second principle is using multiple sources and procedures to collect comprehensive data. The process includes direct communication with company officers, analysis of public documents such as annual report and 10-K, collecting information from government and NGO, conduct interviews with representatives from various stakeholder groups, and scanning of media such as local and global news

resources. All this data is analyzed by the firm who makes the social ranking to arrive at an aggregated CSP ranking. Such comprehensive data from several different resources can serve for triangulation, improving the reliability of the calculated result.

Such a scoring process of social responsibility is undertaken today by numerous companies that have emerged worldwide, with some serving local markets, while others operate also on the global markets. Aiming to get a thorough understanding of this tool for measuring of social responsibility, a specific example of this method is presented – the KLD social ranking.

#### *KLD - Corporate Social Rating*

The KLD social ranking is done by KLD Research & Analytics, Inc. – a leading, U.S.A. based company in the field of social responsibility ranking ([www.kld.com](http://www.kld.com)). The firm, which was a pioneer in social ranking and currently (2009) celebrates 20 years of social ranking, provides the following self profile:

*"KLD Research & Analytics, Inc. is an independent investment research firm providing management tools to professionals integrating environmental, social and governance factors (ESG) into their investment decisions" (KLD home page on web site [www.kld.com](http://www.kld.com)).*

KLD provides social responsibility ranking through its service product named 'SOCRATES' – The Corporate Social Rating Monitor. The product profile provides the following description:

*"SOCRATES is a comprehensive research database, measuring the social and environmental performance of corporations. The web-based database contains social, environmental, and governance research on more than 4,000 companies in more than 50 global markets. KLD evaluates over 3,000 U.S. corporations for social and environmental performance on more than 280 data points using a proprietary ratings process covering community relations, corporate governance, diversity, employee relations, human rights, products, and the environment" (KLD Socrates page on web site [www.kld.com](http://www.kld.com)).*

SOCRATES monitors a wide range of social and environmental indicators related to the various stakeholder groups, following the concept of multi-dimensional construct

in alignment with the stakeholder theory. The company describes what indicators are monitored, as well as the process through which it is done. This description is given in the product data on the internet web site, includes the following data:

Measured indicators:

- **Employee Relations:** Health and Safety, Retirement Benefits, Union Relations, Cash Profit Sharing, Employee Involvement, Workforce Reductions;
- **Human Rights:** Labour Rights, Relations with Indigenous Peoples;
- **Product:** Benefits the Economically Disadvantaged, Quality, R&D/Innovation, Antitrust, Marketing/Contracting Controversy, Safety;
- **Community:** Charitable Giving, Innovative Giving, Support for Education, Support for Housing, Volunteer Programs;
- **Environment:** Clean Energy, Management Systems, Pollution Prevention, Recycling, Agricultural Chemicals, Hazardous Waste, Ozone Depleting Chemicals, Regulatory Problems, Substantial Emissions;
- **Diversity:** Board of Directors, CEO, Employment of the Disabled, Gay and Lesbian Policies, Promotion, Women and Minority Contracting, Work/Life Benefits;
- **Corporate Governance:** Compensation, Ownership, Political Accountability, Transparency;

KLD runs an extensive research process to arrive at social rating of corporations. Data is collected in a disciplined process from a wide variety of company, government, non-government organization and media sources. KLD tracks each company through more than 10,000 global media sources daily. The research process and knowledge base includes:

- Company – Direct communication with company officers;
- Access to global research by 10 global SRI research firms (SiRi\*) covering non-US companies; (\*SiRi Company is a coalition of over ten research organizations dedicated to the global advancement of social investing)
- Media – Over 10,000 global news sources reviewed daily;

- Public Documents – All major SEC filings reviewed, including 10-K, annual report, and proxy;
- Government and NGO Information – Including Department of Labour, EPA, Human Rights Watch, OSHA, CANNICOR, CERIES, ICCR, DoD.

Once the information is collected, KLD analyses the data and rates the social, environmental and governance performance of companies. A detailed description of KLD's SOCRATES Social Responsibility Rating, as well as the process to arriving at the rating, as published by KLD Inc., is provided in Appendix 4.2.

The KLS social responsibility rating has been an example for the External Evaluation-Based Measure of Social Performance. This method of obtaining social responsibility rating is based on two principles: External evaluation of CSR along the dimensions of the stakeholder theory, and Integration of multiple gauging techniques, including partial use of data obtained through the use of the previous measurement systems. Other firms worldwide perform measurement and rating of social responsibility according to this methodology. 'MAALA' - a non-profit organization in Israel is performing measurement and rating of social responsibility of corporations in Israel, in a similar methodology as KLD. More details on this will be presented in the research design chapter.

Although, this methodology of CSR rating has been said to be rigorous and reliable (Griffin and Mahon, 1997; Rowley and Berman, 2000; Porter and Kramer, 2006); others pointed out some flaws in the methodology (Margolis and Walsh, 2001). Margolis and Walsh (2001) claimed that although the stakeholder oriented measures of CSP is considered to provide a good measure for each discrete dimension of social responsibility, there is a controversy over its aggregated form. Such aggregated measure of the firm's social performance is needed when research seek to compare companies along a single yardstick. They (Margolis and Walsh, 2001) explain that the aggregated measure is arrived through the use of relative weighted assigned to each stakeholder group, which is based on the flawed assumption that the various dimensions of social responsibility can be compared.



### **Summary on Measuring CSP**

This section has investigated the theoretical perspective of the operationalisation and measuring CSP. The great difficulty to come up with a measure of CSP is due to the vogue concept of social responsibility in itself (Griffin and Mahon, 1997; Rowley and Berman, 2000; Margolis and Walsh, 2001). We explored four distinctive methods used in past research: (1) Corporate Disclosure-Based Qualitative text-based reports; (2) Corporate Disclosure-Based Quantitative numerical-based reports; (3) External Evaluation Survey-Based Subjective Measures; (4) External Evaluation Stakeholder-Based Measures.

The first three measures have been found not to be very useful in themselves. First, corporate disclosure-based measures of CSP suffer from low validity since they rely on corporate disclosure data which can be biased by the firms' own interests (Griffin and Mahon, 1997; Margolis and Walsh, 2001). Second, survey-based measures of CSP suffer conceptually from being highly subjective (Griffin and Mahon, 1997). Thus, the External Evaluation Stakeholder-Based Measures was found to be the most reliable method.

### **Operationalisation and Measurement of CFP**

This section will explore the theoretical perspective underpinning the selection of measures of financial performance. It will review the various measures of financial performance that have been used, and the considerations in adopting a certain practice. This understanding will be used later on in adopting a certain practice for my research.

Margolis and Walsh (2001:14-15) noted that "One might think that measuring financial performance is a straightforward task." As opposed to the amorphous nature of social responsibility which can not be easily quantified, financial matters are generally regarded a very precise issue (Griffin and Mahon, 1997). However, based on their review of past research, Margolis and Walsh (2001) went on to say that this has not been the case – financial performance has been measured in many ways.

A wide range of measures of financial performance have been used, by studies on the relationship between corporate social responsibility and financial performance, during

the last three decades. Griffin and Mahon (1997), in their review of twenty five years of research on the issue, have counted 80 different measures of corporate financial performance (CFP) that have been used in just 51 studies. Table 4-2 lists the financial performance that their study identified. Similarly, Margolis and Walsh (2001) found that financial performances were measured in 70 different ways in 95 studies.

Return on equity (4 types)	Equity	Return on sales
Return on sales (2 types)	Return on assets (5 types)	Liquidity (3 types)
Net earnings	Asset age (2 types)	Risk measures (4 types)
Return on investment (2 types)	Asset turnover (2 types)	Market measures (4 types)
Earning per share (2 types)	Size (5 types)	Ownership (2 types)
Profit margin	Return on assets (3 types)	Others (6 types)
Sales/employee		

**Table 4-2 Measures of financial performance used in past research (after Griffin and Mahon, 1997)**

While testing whether higher social responsibility will have positive affect on its business performance, the immediate question that comes to mind is what constitutes financial success of a firm. Various view points have been used in past research, as reported by Griffin and Mahon (1997).

Jensen (2001) argued that one cannot test for value maximization of a firm unless a 'Corporate Objective Function' is defined. Given that the success of a firm can be interpreted in different ways, one has to define what the dimensions that need to be maximized are. Total value is not just the value of the equity but may also include the market values of all other financial claims on the firm. In his paper he also suggested that it was important to consider long run maximization elements which could prove important to stakeholders.

Although wide variety of financial measures has been used, they have been divided into two main categories – accounting based measures and market based measures

(Griffin and Mahon, 1997; Margolis and Walsh, 2001). Those two types of CSP measures represent different perspectives on how the firm's performance is evaluated (Holthausen and Larcker, 1992; Margolis and Walsh, 2001).

Margolis and Walsh (2001: 14-15) explained that "Accounting measures capture past performance and thus indicate how that historical record has been influenced by, or went on to influence, social performance. In contrast, market measures are forward looking, taken to reflect estimates about the net present value of expected future earnings". The difference in their perspective suggests that there is no preference of one measure over the other, but rather that the selected measures should suit the theoretical perspective of the research. Each of the two categories of CFP has been used through various indicators as, with the most common ones (Griffin and Mahon, 1997) detailed in the next paragraphs.

### **Market-Based Measures of Financial Performance**

Market-base measures of financial performance of a firm are, as implied by the name, based on market indexes such as a stock market price (Amit and Livant, 1988). Stock market prices encompass the expectation of the shareholders towards the future earnings and value of a firm. It is therefore that market based measures of financial performance are forward looking (Baysinger and Hoskisson, 1989; Rowe and Morrow, 1999). According to Griffin and Mahon (1997) the most widely used market measures include: Share Price, Price to Earnings (P/E) ratio (one or multiple years), and market value coefficients, described hereafter.

**The P/E ratio** (price-to-earnings ratio) of a stock is a measure of the price paid for a share relative to the income or profit earned by the firm per share. A higher P/E ratio means that investors are paying more for each unit of income. It is a valuation ratio included in other financial ratios. The reciprocal of the P/E ratio is known as the earnings yield.

$\text{P/E ratio} = \frac{\text{Price per Share}}{\text{Earning per Share}}$
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The price per share (numerator) is the market price of a single share of the stock. The earnings per share (denominator) is the net income of the company for the most recent 12 month period, divided by number of shares outstanding.

During the last decade new measures of financial performance of corporations have been introduced that are mainly market based. A major development has been the introduction of Economic Value Added (EVA) and Market Value Added (MVA). The new measures have been introduced by a private consulting firm 'Stern Stewart & Co.'.

**Economic Value Added (EVA):** EVS as defined by Stern Stewart "is net operating profit minus an appropriate charge for the opportunity cost of all capital invested in an enterprise. As such, EVA is an estimate of true "economic" profit, or the amount by which earnings exceed or fall short of the required minimum rate of return those shareholders and lenders could get by investing in other securities of comparable risk".

$$\text{EVA} = \text{Non operating Profit After Taxes (NOPAT)} - \left[ \text{Capital} \times \text{The Cost of Capital} \right]$$

**Market Value Added (MVA):** is the difference between the market value of the debt and equity and the total capital employed in the business. A company's MVA is the total wealth, or NPV, that managers have created as well as the total current and future EVA expected (Stern Stewart & Co.).

The question of what theoretical perspective calls for the use of market based measures of financial performance has been addressed by authors (Griffin and Mahon, 1997; Margolis and Walsh, 2001). It was suggested that because market based measures are forward looking, they best suit research design which looks at the expectations of corporation future performance in relation to contemporary social issues (Griffin and Mahon, 1997; Margolis and Walsh, 2001). This argument fits 'Lead-Lag' causal research design. In such research design the hypothesis is that higher social responsibility during a certain period will cause better financial performance in the next financial period. Thus, the measure of financial performance

should be forward looking to represent the expectations of the shareholders based on the knowledge that the firm is currently engaged in higher level of CSR.

Another research design that would call for the use of future looking measures of financial performance is that of 'event study' (Berman et al., 1995). Such research design will normally test the effects of environmental misconduct or poor social practice, on the market value of the company as reflected by its share price (Berman et al., 1995). Again, in such research the market returns are based on expectations regarding the entire future of the firm.

A different argument for using market based measures of financial performance was advocated by McGuire et al. (1988). Their research used market based measures of financial performance, based on the argument that market based indicators are less susceptible to different accounting procedures. Additionally, their view was that market based measures are more reliable as they represent the collective wisdom of investor's evaluation of the ability of a firm to generate future economic earnings.

The main criticism on the use of market-based indicators is that they are not accurate and trustful (Vance, 1975; Shane and Spicer, 1983; Ullmann, 1985). Vance (1975) has shown that the use of market-based indicators produced diverse results. He re-examined previous research by Moskowitz (1972), while extending the time period for analysis from 6 months to 3 years, thereby producing results which contradict Moskowitz by indicating negative CSP/CFP relationship. Additionally, Shane and Spicer (1983) claimed that market measures should not be used because they may be assessing more than just the financial outcome of the organizations. Similarly, Ullmann (1985) argued against the use of market-based indicators because they represented investor's valuation of firm's performance which could not be taken to be objective.

In order to overcome the drawbacks of market based measures, Griffin and Mahon (1997) suggested using them in conjunction with other accounting based measures of financial performance. In this way, when several various measures are used, they compensate the drawback of each individual measure and provide for a more reliable outcome (Griffin and Mahon, 1997). Following this practice of research design, there

are several studies that used the more recent market based measure of MVA together with other accounting based measures of financial performance (Verschoor, 1998; Hillman and Keim, 2001; Webley and More, 2003).

Verschoor (1998) undertook one of the first major studies to use MVA as measure of financial performance. In his research Verschoor tested whether there is a link between ethical commitments of a firm to its financial performance. For measure of financial performance the study used MVA data that was published by Fortune magazine for the leading industrial and service corporations in the US. However, Verschoor's research used two additional measures of financial performance, in addition to the MVA. One of the other measures was a weighted financial ranking by Business Week magazine which was based on eight different financial measures, including total return for one and three years, net margin, and return of equity. Thus, accounting measures were used together with the MVA market based measure.

Similarly, Webley and More (2003) used market based MVA measure together with other accounting based measures of financial performance. Their research, named "Does Business Ethics Pay?", applied a similar methodology to that of Verschoor (1998) to investigate the relationship between CSP and CFP within the UK market.

Webley and More (2003) used in their research four measures of financial performance including Market Value Added (MVA), Economic Value Added (EVA), Price Earning Ratio (P/E) and Return on Capital Employed (ROCE), thus incorporating market based measures together with accounting based measures of financial performance.

### **Accounting-Based Performance Measures**

Accounting-base measures of financial performance of a firm are, as implied by the name, based on accounting practices for financial reporting. Accounting based financial reporting has been in use for periodical reporting on the business outcomes specifically as part of annual reports of a firm, as they provide historical perspective on what the firm has achieved financially.

According to the review by Griffin and Mahon (1997), the main indicators of accounting base financial performance used, include: return on equity (ROE), return

on assets (ROA), return on sales (ROS), net income (earnings), and return on investment (ROI). Those financial indicators have been in use to measure yearly performance as well as multi-year performance such as 2-year to 5-year results. Return on equity (ROE), reflects the profitability of the firm by measuring the investors' return. This variable is measured by the mean net income/owners' equity. Return on assets (ROA), reflects the asset utilization of the firm. This variable is measured by net income/assets. ROA is related to ROE by financial leverage (total assets/total equity). Return on sales (ROS), reflects the average profit margin attained by the portfolio of products offered by the firm. This variable is measured by the total net profit/sales.

Reviews of past research (Griffin and Mahon, 1997; Margolis and Walsh, 2001) found that most studies on the subject of the relationship between CSP and CFP used accounting based measures of financial performance of companies. Moreover, the two measures that have been most widely used, and are generally considered to capture major dimensions of financial performance with high reliability, are ROE and ROA (Margolis and Walsh, 2001; Moore, 2001).

Accounting based measures of financial performance represent past performance, therefore such measures should be used when the research design refers to past performance of companies. As most of the studies in the field were looking at past periods to test the relationship between CSP and CFP, it is natural that they usually selected accounting based measures (Griffin and Mahon, 1997).

There has been a practice of using several accounting based measures is observed in several major studies (Griffin and Mahon, 1997; Preston and O'Bannon, 1997; Waddock and Graves, 1997). For example, Griffin and Mahon (1997) used five different measures of financial performance, all of which are accounting based indicators. These measures included return on equity, return on assets, 5-year return on sales. Similarly, Preston and O'Bannon (1997), who followed the recommendation by Griffin and Mahon (1997), used several accounting based measures for financial performance, including return on assets (ROA), return on equity (ROE), and return on investment (ROI). Yet another example is the research by Waddock and Graves (1997) that used six measures for financial performance, all of them accounting based

measures. In their research they used ROA, ROE, and ROS, dept/asset ratio, total sales and total assets (for size).

Although, most of the studies that used accounting based measures, tended to use standard general measures such as ROE, ROA, sometimes writers have used an additional measure that were specific to their research context. For example, Simpson and Kohers (2002) studied the relationship between CSP and CFP within the UK banking industry. In addition to using ROA, they also used the specific measure – loan losses – which is a unique measure for the banking industry.

Accounting based measures have been regarded as more reliable and to better reflect the firm's financial performance (Griffin and Mahon, 1997), however drawbacks have been pointed out as well (Branch, 1983; McGuire et al., 1988). One of the main critiques was that they may suffer from managerial manipulation and differences in accounting procedures, which will render them less objective (Brilloff, 1972; Branch, 1983).

### **Corporate Financial Performance Data**

Researchers had to obtain data on the financial performance of corporation in order to correlate them to various forms of social responsibility. While the selection of the most appropriate measure of financial performance might not be easy, and requires careful consideration to match the theoretical perspective of the research, the numerical quantification is very precise. With most of the firms within the framework of investigation being traded in some stock exchange, the availability of financial data to the public is compulsory by the regulations of the fair trading. This means that all the original audited financial data, which is required for the calculations of most accounting and market based measures of financial performance, can be obtained from public domain sources.

Although most of the source data is available, the actual calculation of the various financial indexes might prove daunting for several reasons. First, some financial indexes are not directly spelled from the publicized data, but require rather complicated calculations. Second, as explained previously, in many cases several financial measures have been used for each firm, resulting in further extensive job of



calculations. Thirdly, many studies used to review tens or even hundreds of companies, such calculation of various financial measures for all the companies could prove to be laborious and grueling.

However, quite often, researchers did not have to work hard to access financial data. Several sources providing detailed calculated financial indexes and data are usually available such as Stock Exchange Services, institutions affiliated to stock exchanges, leading financial newspapers and magazines and leading consulting firms. Some of these sources are briefly reviewed below.

- *Stock Exchanges*: Stock exchanges worldwide provide financial data about the companies which are traded within them.
- *Financial Newspapers and Magazines*: Major leading newspapers and magazines provide periodical financial data on leading companies. Examples include: *Fortune*: US based financial magazine. Fortune keeps track, with its Fortune 1000 ranking, on the financial performance of leading firms in the US and worldwide. *Business Week*: US based financial magazine. The newspaper provides the '*Business Week 1000*', which reports financial facts about the 1000 largest publicly held companies, including these from the S&P 500 Index. Business Week's Global 1000 rank the top companies from 23 countries according to their market value with additional financial data. *Financial Times*: UK based financial newspaper. Manage the 'Company financials' data resource which provide in depth balance sheet information and business analysis on more than 18,000 public companies worldwide.
- *Other Data Sources*: Private financial and consulting firms, and others: Examples include: *S&P (Compustat)*: Standard & Poor's is the world's foremost provider of independent credit ranking, indices, risk evaluation, investment research and data. One of its key data bases is the 'Compustat'. Compustat is the premier supplier of fundamental company, index and industry information and produces a variety of databases and software products for institutional investors, financial and corporate clients. S&P holds also an Israeli branch which provides financial data regarding the Israeli market and public companies. *Stern Stewart & Co.*: US based consulting firm.

Compiles EVA and MVA data bases for leading firms in the US and worldwide. The 'US 1000 EVA/MVA Annual Ranking Database' includes 20 years of historical data for EVA, NOPAT, Capital, Return on Capital, Cost of Capital and FGV, and 15 years of data for MV and MVA.

### **Summary on Measuring CFP**

This section has discussed the theoretical perspective of measuring CFP; as such measure is required for my research. Although financial matters are regarded to be a precise issue, a wide variety of different CFP measures have been used in past research (Griffin and Mahon, 1997; Margolis and Walsh, 2002).

The theoretical perspective had presented the two main categories of CFP measures – market based and accounting based measures. Those categories are very different in their theoretical perspective. The two types of measures evaluate the financial performance of a company from different perspectives (Holthausen and Larcker, 1992). Market based measures of financial performance reflect estimates about expected future earnings. In contrast, accounting measures capture past performance.

The selection of a certain set of financial performance should be based on matching their theoretical perspective to the research design. When the research design is looking for correlation between CSP and CFP while examining past periods, accounting based measures are the correct choice as they measure past performance. Indeed, this was the case for the majority of past research on the issue, both in terms of research design as well as selection of accounting based measures of CSP (Griffin and Mahon, 1997; Margolis and Walsh, 2002).

A great number of the studies on the relationship between CSP and CFP used more than one measure of financial performance. This practice has also been recommended by Griffin and Mahon (1997), who suggested that multiple dimensions of corporate financial performance should be employed. The use of multiple dimensions of corporate financial performance within the context of a single research follows the practice of data triangulation, and provides for higher validity and reliability.

Following the recommendation to use more than a single measure of financial performance, several studies use both accounting based and market based measures (McGuire, Sundgren and Schneeweis, 1988).

### **Results of Past Empirical Research**

Earlier in this chapter I have reviewed the variability of extant studies with regard to two issues - their theoretical perspective and the Operationalisation of CSP and CFP variables. The third issue of variability that comes up from past research is the various and inconsistent results regarding the relationship between corporate social and financial performance. Having over 100 studies of this relationship done in the past four decades (Griffin and Mahon, 1997; Margolis and Walsh, 2001; Orlitzky et al., 2003), exhibiting various results, calls for investigation that can provide insights which might be applicable for further research.

Authors including Griffin and Mahon (1997) were reviewing 51 articles between 1972 and 1997; Margolis and Walsh (2001) reviewing 95 empirical studies on this subject from 1972 to 2000; and Orlitzky et al. (2003) reviewing 52 studies. All concluded that there has been inconsistency in the results. Thus, Griffin and Mahon (1997) concluded that: "Although numerous researchers have explored the empirical relationship between corporate social performance (CSP) and corporate financial performance (CFP), no definitive consensus exists" (1997:6). Relationships between CSP and CFP have been found to be alternately positive, negative, and neutral. A classification of the results as reported by Griffin and Mahon (1997) is listed in Table 4.3 (74-75).

Positive Correlation	
Moskowitz,1972 Bragdon and Marlin, 1972 Bowman and Haire, 1975 Moskowitz,1975 Parket and Eilbert, 1975 Belkaoui,1976 Heinze, 1976 Sturdivant and Ginter, 1977 Bowman, 1978 Ingram, 1978	Fry, Keim, and Meiners,1982 Newgren et al., 1985 Rockness, Schlachter, and Rockness, 1986 Cowen, Ferreri, and Parker, 1987 Spencer and Taylor, 1987 Wokutch and Spencer, 1987 Morris, Rehbein, Hosseini, and Armacost,1990 Riahi-Belkaoui, 1992 Hart and Ahuja, 1994 Johnson and Greening, 1994

Positive Correlation	
Spicer, 1978	Waddock and Graves, 1996
Negative Correlation	
Vance, 1975 Shane and Spicer, 1983 Wier, 1983 Jarrell and Peltzman, 1985 Pruitt and Peterson, 1986 Cross, 1987	Davidson, Chandy, and Eckbo, 1983 Shane and Spicer, 1983 Strachan, Smith, and Beedles, 1983 Davidson and Worrell, 1988 Hoffer, Pruitt, and Reilly, 1988 Bromiley and Marcus, 1989
No/Inconclusive Correlation	
Alexander and Buchholz, 1978 Abbott and Monsen, 1979 Ingram and Frazier, 1983	Ingram and Frazier, 1983 Aupperle, Carroll, and Hatfield, 1985 Freedman and Jaggi, 1986

**Table 4-3 Results of the CSP to CFP relationship in studies reviewed by Griffin and Mahon (1997)**

Authors have attributed the variety of results to differences in research methods (Griffin and Mahon, 1997; Orlitzky et al., 2003). Although such variety existed, those authors tried to come up with an overall conclusion based on aggregated results. Griffin and Mahon (1997) used 'vote-counting' technique in their review of 51 past studies, to produce an overall conclusion. Their vote-counting simply coded studies as showing positive, negative, or statistically non-significant results, to conclude that the majority of studies indicate positive relationship. Similarly, Roman, Hayibor and Agle (1999), who re-examined the review conducted by Griffin and Mahon (1997) applying different interpretation to the results, concluded that there is a strong accumulating evidence of positive relationship between CSP and CFP. Yet another meta-analysis of past research conducted by Orlitzky, Schmidt and Rynes (2003), showed that "Corporate social performance and financial performance are generally positively related across a wide variety of industry and study contexts" (2003:406).

Although the aggregation of studies, as shown above, indicated an overall positive relationship between corporate social and financial performance, it might not reveal the true nature of that relationship (Moore, 2001; Margolis and Walsh, 2001). The main flaw with the aggregation approach was that it sought to find out a linear relationship – apparently positive, implying that studies that did not align with this conclusion had some faults.

A different approach has been taken by others who attributed the variety in results to a non-linear relationship between corporate social and financial performance (Bowman and Hire, 1975; Sturdivant and Ginter, 1977; Moore, 2001). Those authors suggested that such non-linear relationship, which has both positive and negative segments, could better explain the various finding with regard to the direction of the relationship. Moreover, the majority of authors of this school of thought suggested that the relationship resembles an inverted U-shape curve rising from left to right until reaching a point of maximum, before declining again (Sturdivant and Ginter, 1977; Moore, 2001). Such a conceptual curve is shown in Figure 3.1 (43).

An inverted U-shape relationship, as explained in chapter 3, is the result of the opposing forces of costs and benefits of social responsibility, as theorized by several authors (Sturdivant and Ginter, 1977; Jones, 1995; McWilliams and Siegel, 2001; Barnea and Rubin, 2005); as well as my formulation of the 'Unified Theory of the CSP-to-CFP Link' (Marom, 2006).

The implication of this understanding for future research is that such research need not to look explicitly for a positive linear relationship, but rather hypothesizes that a non-linear relationship exist, as suggested above.

### **Chapter Summary**

This chapter has explored past empirical research on the relationship between corporate social and financial performance, that provides insights for the design of this research. This investigation provided an understanding of three main issues that guided past research and has to be considered for my research: First, the various theoretical perspectives that can guide a research on the issue. Second, the possible approach to the operationalisation and measurement of the two variables – social and financial performance. Third, what can be expected and hypothesized with regard to the outcomes of such research. Those understandings will be used in the design of my research which is presented in the next chapter.

## **Chapter 5 Conceptual Framework and the Research Inquiry**

### **Introduction**

This chapter presents the conceptual framework of the research which explains the main dimensions of the research, as well as defining the purpose of the research and the research question. The conceptual framework draws on the theoretical perspective which was presented in chapters 2, 3 and 4. It uses these ideas and concepts to build the framework of this research. It does so by providing links between the literature and the elements of the conceptual framework, and so defines the interrelation between the various components.

The conceptual framework, as defined in this chapter, serves several roles as suggested by Trafford and Leshem (2008:44), including: "... bridging theory and practice, concept mapping, focal theory, picture of the theoretical territory, theoretical scaffolding." Thus, my conceptual framework will serve afterwards to define the research design which is detailed in the next chapter.

### **The Research Problem**

This research investigated the relationship between CSR and CFP for corporations in Israel.

### **Research Purpose**

The purpose of the study was to find evidence, within the context of companies in Israel; that corporate social responsibility can lead to improved financial performance. As the literature review has shown significant evidence that this is the case in leading western economies, the research purpose can also be stated as looking for evidence that a similar CSR-to-CFP relationship exist in Israel and in those western economies. Drawing on the literature review, CSR was defined as the aggregated value of social responsibility measured along the dimensions of the stakeholder theory, by an independent non-profit organization. CFP were based on their ROA, ROE, and P/E calculated from their audited financial statements.

## **Research Question**

In defining the research question I followed suggestions by Collis and Hussey (2003: 124-126) who cited various writers (Kerlinger, 1986; Black, 1993). Collis and Hussey suggest (2003: 125) that research questions for a positivistic study should include three attributes: (1) Express a relationship between variables (CSP and CFP), (2) Be stated in unambiguous terms in question form; and (3) Imply the possibility of empirical testing. Additionally, Collis and Hussey (2003: 124) recommend that a positivistic study should have a specific research question, followed by a number of hypotheses. Additionally, following the positivistic paradigm, Collis and Hussey, (2003: 125) suggest that research questions can be stated as hypotheses. The hypothesis should identify the independent variable and the dependent variable. A hypothesis is a statement about the relationship between variables. The null hypothesis ( $H_0$ ) states that the two variables are independent of one another and the alternate hypothesis ( $H_1$ ) states that they are associated with one another. The null hypothesis is always stated first.

Accordingly, and based on the research purpose, my research question can be stated as:

Is there a positive relationship between CSR and CFP, for companies in Israel, supporting investment in CSR to a certain level beyond which this relationship turns negative?

This research question is followed by the following specific hypotheses to be tested:

Hypothesis 1:

$H_0$ : The CFP does not increase as the level of CSP increases

$H_1$ : The CFP increases as the level of CSP increases

Hypothesis 2:

$H_0$ : There is no peak point beyond which CFP decreases as the level of CSP increases

$H_1$ : There is a peak point beyond which CFP decreases as the level of CSP increases

Those hypotheses provide the precise issues that I intended to explore within the research question. They state the assumptions about the relationships between the variables, and so the testing of those statements provides evidence and conclusions that would allow me to answer the research question.

## **Mapping of the Research Area**

Corporate Social Responsibility (CSR) is a form of conduct which aligns business operations with social values through balancing and integration of economic, environmental, and social imperatives (Carroll, 1979). Since the middle of the 20th century, there has been an increasing expectations from corporations to adopt social responsible conduct of their business operation (Bowen, 1953; Carroll, 1999). At first, the base for such expectations were grounded in moral reasoning based on the perception that corporations have to reduced, and compensate for, the social and environmental problems cause by their operations (McGuire, 1963; Davis and Blomstrom, 1966; Carroll, 1979). However, later on came a growing awareness that social responsibility can lead to improved financial performance (Davis, 1960; Johnson, 1971; Griffin and Mahon, 1997; Carroll, 1999; Orlitzky et al., 2003). This led to the recognition that by including social responsibilities within their overall business strategy, corporations actually promote their own business interests (Griffin and Mahon, 1997; Orlitzky et al., 2003).

The introduction of the stakeholder theory (Freeman, 1984) has been instrumental in understanding the various mechanisms through which social responsibility had impact on financial performance (Donaldson and Preston, 1995). The stakeholders of the firm have been defined as these constituencies who can affect or be affected by the achievement of the organization's objectives (Freeman, 1984). Accordingly, major stakeholder groups have been identified to include employees, customers, suppliers, regulatory, adjacent community, and society by large (Donaldson and Preston, 1995; Mitchell et al., 1997).

Several theories have been introduced to explain how social responsibility may affect corporate financial performance. If stakeholders' expectations are not met, and corporate operations are perceived not to be in alignment with their interests, then stakeholders can induce negative impact through their various interface mechanisms with the firm. Alternatively, satisfied stakeholders, appreciating acts of social responsibility on the part of the firm, can induce positive impact on the firms' business creating favourable conditions which may result in enhanced financial performance. This positive impact that social responsibility has over financial performance is the



core of several theories and models including Stakeholder Management, Social impact hypothesis, and the Resource-Based View. Those theories and models assume that competitive advantage and enhanced financial performance can be achieved through corporate social responsibility which affects the stakeholders (Freeman, 1984; Donaldson and Preston, 1995; Mitchell et al., 1997; Preble, 2005; Porter and Kramer, 2006).

However, the resources invested in creating social responsible outputs are translated to additional costs borne by the firm. Those additional costs are part of the expenditure side of the firms' balance sheet, thus reducing financial performance. This is the viewpoint of the trade-off hypothesis which assumes negative impact of social responsibility on financial performance (Aupperle, Carroll and Hatfield, 1985; Ullmann, 1985; McGuire et al., 1988; Preston and O'Bannon, 1997).

These various theories provided explanations for two opposing directions of impact that social responsibility may have over financial performance – positive and negative. This was confirmed by the body of past research that has yielded positive, negative, and non conclusive relationship between social responsibility and financial performance. Although, meta-analysis research by Griffin and Mahon (1997) and Orlitzky et al., (2003) has shown that the majority of past research has yielded positive relationship between corporate social responsibility and financial performance. Thus, a space has been created for a theory that integrates the opposing driving forces of social responsibility, with regard to their impact on financial performance, into a single model.

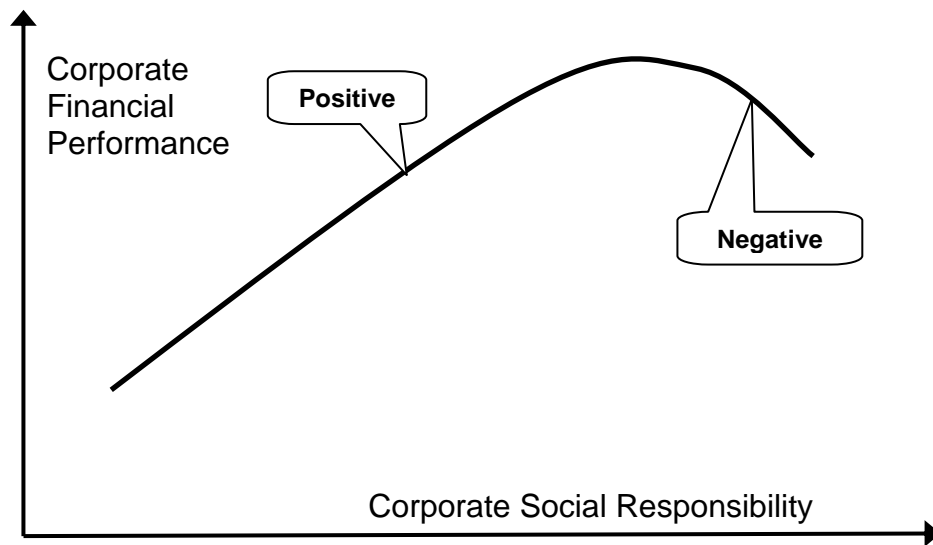
### **The Focal Theory**

The focal theory of the research builds on the relationship between corporate social responsibility and financial performance, as explored in the literature review in chapter 3. The review revealed several theories regarding the cause and direction of impact that CSR might have on financial performance. Some of the models have suggested a linear relationship, either positive or negative, between CSP and CFP, including:

- The theories of 'Stakeholder Management', 'Social impact hypothesis', and the 'Resource-Based View'; suggested a positive impact of social responsibility on financial performance;
- The 'Trade-off Hypothesis' suggested a negative impact of social responsibility on financial performance;

However, because of the mixed results several authors (Sturdivant and Ginter, 1977; Jones, 1995; McWilliams and Siegel, 2001) have suggested a non-linear relationship which can have positive and negative values at various parts of the relationship. The main points reported in the literature review with regard to non-linear relationship included:

- An integrated model, suggested by Jones (1995) and McWilliams and Siegel (2001), was based on supply and demand of CSR. McWilliams and Siegel (2001) argued that firms will produce social performance outputs that will be in equilibrium with the demand by stakeholders, to arrive at profit maximizing level;
- Overall, the body of past research has found substantiation for all directions of relationships – positive, negative, and neutral. This fact has resulted in a call for a non-linear relationship model between social and financial performance, as opposed to the linear models that suggested either positive or negative direction (Jones, 1995; McWilliams and Siegel, 2001; Moore, 2001);
- Non-linear relationship has been found in past research (Bowman and Hire, 1975; Sturdivant and Ginter, 1977). The finding of those studies suggested that the relationship between social and financial performance are not simple monotonic plot, rising from left to right, but rather resemble inverted U-shape curve. This suggested an optimal level of social responsibility, for which beyond it financial performance will decrease with further increase of social responsibility. Such a conceptual curve is presented in Figure 5.1 (82);
- Finding of non-linear relationship suggested that the curve is asymmetrical with the left tail (low SCR) lower than the right (high CSR). This means that most of the companies that are involved in some level of social responsibility fall within the positive part of the relationship. This provides an explanation for the majority positive finding in past research;



**Figure 5-1 Positive and negative relationship between CSP and CFP**

My research is assuming a non-linear relationship because it can better explain past findings. Moreover, I have also argued for such non-linear approach in a previous published article (Marom, 2006), introducing the 'Unified Theory of the CSP-to-CFP Link'. The unified theory considers Social Outputs to be Social Products as suggested by Murray and Montanari (1986), arriving at a cost-benefit analysis similar to that suggested by the theory of micro-economics for any output product of a supplier. The components of this cost-benefit analysis are the production function of social responsibility outputs which governs costs, and the supply-and-demand model regarding stakeholders' satisfaction from social outputs, which governs level of rewards they are willing to 'pay back' to the corporate. This model can explain a non-linear, inverted U-shape function, with both positive and negative segments as suggested by past research (See Figure 5-1). Thus, the focal theory for my research assumes a non-linear relationship between CSP and CFP.

### **Bridging Theory and Practice**

The review of the literature, undertaken in the theoretical perspective chapters, revealed several issues that contribute to the conceptual framework for my research.

First, it is not possible to measure directly the effects of a certain social output on a certain stakeholder group, and the resulting impact of those stakeholders on the firms' financial performance (Ullmann, 1985; McWilliams and Siegel, 2000; Tsoutsoura, 2004). Ullmann (1985) pointed out that it would be impossible to correctly associate

specific social responsibility practice to change in revenues or profitability. Similarly, Tsoutsoura (2004) noted that it would not be possible to identify exactly the mechanism through which social outputs affect specific stakeholders, and thereof with specific bottom-line benefits. Moreover, there are suggestions (McGuire et al., 1988; Orlitzky et al., 2003; Tsoutsoura, 2004) that the social outputs and their associated returns do not occur normally at the same time frame, which further prevent their association.

If the exact chain of events and mechanism cannot be reliably identified, then the only way to investigate the relationship between corporate social responsibility and financial performance is to gauge them at the two end points. At one end it is possible to measure the level of the social outputs of the firm, and then measure the financial performance on the other end of the relationship. Thus, this research, similar to the practice of past research, will have to measure social responsibility and financial performance at their end points.

Second, the concept of social responsibility cannot be measured directly, as with, for example, measuring the concept of temperature. As discussed within the theoretical perspective part of the thesis, social responsibility is a vague and amorphous concept (Margolis and Walsh, 2001). Thus, whilst the concept of social responsibility cannot be measured directly, it has to be measured through indicators as surrogate factors.

According to Bryman (2004: 66-67) if a concept can not be measured directly, it has to be measured through indicators. Indicators are something that is devised or already exists and that is employed as though it were a measure of the concept. Thus, an indicator can be viewed as an indirect measure of a concept. Very often a single indicator would be insufficient to provide a reliable measure of a concept since it may not capture a portion of the concept rather than the whole concept. In such cases a multiple-indicator measure of a concept would be necessary.

This is the approach that I adopted with regard to the concept of social responsibility. It will be measured through an indirect, indicator based, multi-dimensional construct as explained in the theoretical perspective. The design process for this instrument is explained in Chapter 6.

Third, the focal theory is expected to produce a non-linear relationship between corporate social responsibility and financial performance. According to the focal theory, it is predicted that financial performance will rise with increase in social responsibility, reaching a maximum point and then declining with further increase in social responsibility. Based on past research this phenomenon is best tested in two separate tests – a practice which is also reflected in having two hypotheses instead of a research question.

One type of test gauges the positive segment of the relationship, while the second type of test identifies the existence of a maximum point of which on both sides financial performance decrease. How those two tests have been specifically devised is explained in the research design provided in chapter 6.

### **The Conceptual Framework**

According to Miles and Huberman (1984) the conceptual framework is defined as following:

*"A conceptual framework explains, either graphically or in narrative form, the main dimensions to be studied – the key factors, or variables – and the presumed relationships among them."* (1984:28).

Accordingly, this section will provide a conceptual framework for my research, explaining the key factors, variables and their interrelations. It will describe how my conceptual framework draws on the theoretical perspectives provided in chapters 2, 3 and 4. This explanation is provided in a graphical map and narrative description. Graphically, a map of the conceptual framework of this research is provided in Figure 5.2 (86), which will serve as a support illustration for the explanation. The conceptual framework for my research should be in alignment with the hypotheses set out earlier in the chapter, and will serve later on for the research design in the next chapter.

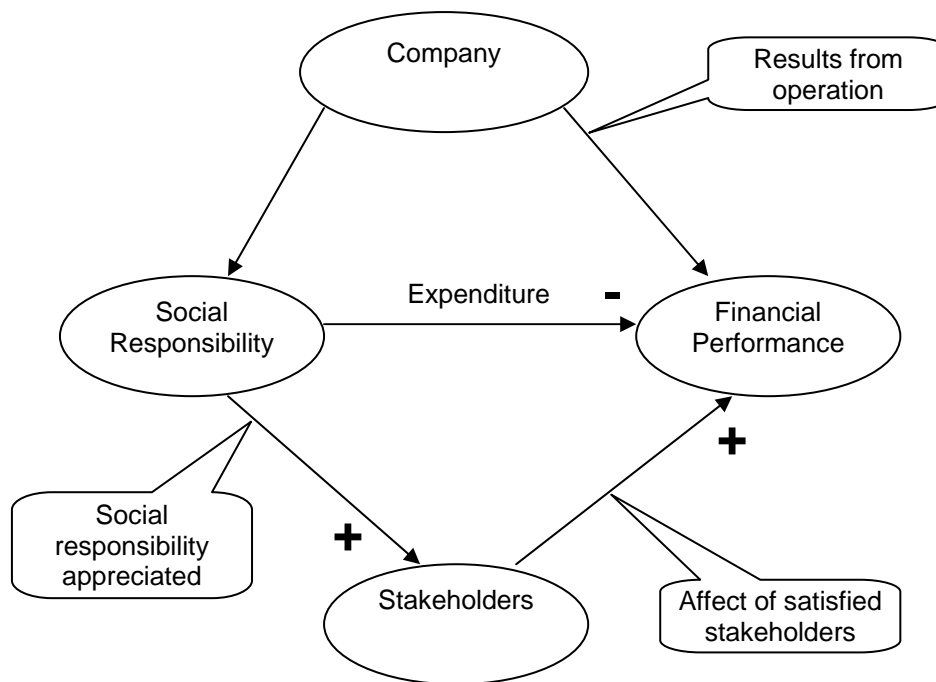
A core concept of this research is corporate social responsibility. This is illustrated as the starting point in the map shown in Figure 5-2 (86). Given the context of my research, it deals with companies in Israel, which are described later on in the research design chapter of the thesis.

CSR, or its measured output – CSP, is one outcome of the company's operation (see Figure 5-2: 86). The definition of CSR has been provided in chapter 2, and will serve this conceptual framework. It stands for actions taken by the company for the benefit of society, originating from moral and ethical stance toward society. Initially or seemingly, such actions of social responsibility are not driven by financial considerations as explained earlier.

A second outcome of the company's operation (see Figure 5-2: 86), which is the reason for the existence of commercial enterprises, is its financial performance. In essence, financial performance is net income from operations, as well as other commercial benefits, which constitutes the return on investment of the owners. As described earlier, the classical economic view was that the only goal of corporations should be to increase their profits, maximising shareholder wealth, and thus corporations should not be engaged in social responsibility (Friedman, 1984).

According to the 'trade-off hypothesis' described earlier, actions of social responsibility require also financial resources from the company, and thus represent an additional expenditure. This is illustrated in Figure 5-2 (86) by the 'expenditure' link between social responsibility and financial performance. Accordingly, such an additional expenditure will cause a decrease in financial performance, indicated by the minus ('-') sign next to this link in the diagram.

However, there is also a positive impact of social responsibility on financial performance, as discussed in chapter 3 within the theoretical perspectives. The stakeholder theory suggests that various stakeholder groups are affected by actions of social responsibility of the firm. This is illustrated in Figure 5-2 (86) by the link from CSR. If the CSR actions positively address the expectations of stakeholders, those stakeholders will be satisfied. Satisfied stakeholders, as suggested by the theories of 'social impact', 'stakeholder management', and 'resource based view'; induce positive impact on the financial performance of the company. This rationale is illustrated in Figure 5-2 (86) by the link from 'stakeholders' to 'financial performance'; having a positive ('+') sign which designates the positive impact according to these theories.



**Figure 5-2 Map of the conceptual framework of the research**

This conceptual framework illustrates that CSR has two distinct impacts on financial performance, with opposing directions. A negative impact due to the costs incurred in producing social responsibility actions and outputs, and a positive impact that results from satisfied stakeholders by the same social outputs.

As suggested by Trafford and Leshem (2008: 44), this conceptual framework for my research follows the theories and empirical findings as reviewed in the theoretical perspective chapters, regarding the CSP-to-CFP relationship in leading western economies. The significance of my theoretical perspective is that it provided a framework of concepts that have the potential to explain and answer my research questions; and thus guide the choice of methodology and methods which are described in the next chapter.

My conceptual framework provides the following guidelines to be used in the research design:

- The research design had to relate to entities which are companies in Israel. Israeli based companies which make up the Tel-Aviv stock exchange 100 index (TA 100) have been selected as explained later on;
- The research design had to collect data on the financial performance and social performance of each company, for the purpose of investigating the link between those two outputs of a company;
- The hypothesis regarding the link between social and financial performance is premised on the existence of stakeholders, who create positive impact on financial performance when their expectations are met by social outputs of the company,

### **Chapter Summary**

The research problem and investigation has been described within the context of the conceptual framework. The investigation is focused on the relationship between social and financial performance of companies in Israel. The research hypotheses assume that this relationship will be similar to that found in western economies, where social responsibility has been found to have both negative and positive impact on financial performance. This conceptual framework leads to the research design which is described in the next chapter.



## **Chapter 6 Research Design**

### **Introduction**

This chapter presents the design for my research. It starts by explaining the paradigm for the research approach. This provides my view on the topic and the perspectives that informed how the research was designed. Next, the methodological approach is explained, the research choices that faced me and the decisions that were made. The methods that were used to collect data in this study are then detailed. Finally, the ethical considerations of the research are explained, and show how it complies with academic and scholarly requirements.

### **Linking the Paradigms**

The paradigm for this research presented a determinist and positivistic view of the topic. I saw the issues to be investigated as possessing causal relationships that were capable of objective examination and expression. The positivist foundation for this paradigm is that ‘...knowledge is hard, real, and capable of being measured...’ as finite quantities (Burrell and Morgan, 1985:1). Assuming that there was a cause and effect relationship between the main variables of corporate social responsibility and financial performance was therefore reflected in the hypotheses to be tested. This aligned my perspectives on the topic with the positivistic epistemological stance on the creation of knowledge through a deductive approach to research that tested theory. In this way the two paradigms are my ‘ways of seeing the world’ that relate theory, as perceptions of the topic, with practice, as investigatory approaches and methods of action (Kuhn, 1996: 109).

### **Methodology**

The research process can be seen as ‘... an organized, systematic and logical process of inquiry. It uses information to answer questions or test hypotheses.’ (Punch, 2000: 7). It stresses the central role of research questions and systematically using empirical data to answer those questions from evidence collected in the field. In order to plan my research I had to determine the appropriate research methodology. Since doctoral research involves contributing to knowledge it was necessary for me to consider the

two alternative approaches to epistemology: deductive (positivistic) and inductive (anti-positivistic) (Burrell and Morgan, 1997:5). Because epistemology is concerned with knowledge and belief about reality researchers are obliged to explain their understanding of knowledge creation. If the research is intended to test theory, a deductive approach would be selected; whereas if the research was intended to develop a theory then an inductive approach would be selected (Trafford and Leshem, 2008: 97).

### **Inductive and deductive research**

The deductive research approach tests the validity of a theory, and may also be referred to as a theory-testing approach. Deductive research transforms general theory into a specific hypothesis that can be tested. Such theory testing approaches begin with a theory from which assumptions are derived and expressed as a hypothesis. These statements represent the essence and focus of the data collection process and its subsequent analysis. Data collected from a large number of respondents, or sources, is analyzed and conclusions are drawn which test the hypothesis and so provide conclusions regarding the original assumptions. Thus, in deductive research researchers test theory and present their conclusions as confirmation or refutation of hypotheses (Bryman, 2004: 8-10). Deductive research enables knowledge to be created by testing theory.

In deductive research the researcher's thinking is highly structured and runs from the general to the specific. Therefore, the deductive research approach is also referred to as 'top-down' process, as it is moving from the general to the particular.

The inductive approach is referred to as 'theory building research', because it develops and formulates theories (Collis and Hussey, 2003:15; Trafford and Leshem, 2008: 143). Thus, data from empirical observation is used to develop general principles about a specific subject. The inductive research approach is often referred to as 'bottom-up' process, since it starts with the specific observations of, or from, a relatively small number of respondents which are used to find patterns that are developed into theory. Since general inferences are induced from particular instances means that although the outcomes are high in validity, they are low in reliability. They are therefore not generalisable because the research cannot be repeated with

identical components and variables. Thus, choosing an inductive research approach means that researchers cannot not claim generalisability for their conclusions (Trafford and Leshem, 2008: 144). Inductive research enables knowledge to be created by developing theory.

### **Quantitative and qualitative research**

Similar to the choice between deductive and inductive methodology, research can also be differentiated by the frequently-used alternative terms of qualitative and quantitative research methods, respectively (Collis and Hussey, 2003:13; Bryman, 2004: 19). Quantitative research involves numeric quantification in the collection and analysis of data. It views social reality as an external objective reality, which is objective, finite and measurable. Researchers are expected to seek objectivity in their research and to be unbiased in that process through detachment in the field. Therefore, quantitative enquiries follow the practices and norms of positivism. Quantitative research is essentially inanimate and data is expressed in quantitative formats.

Through the use of numeric data and the control of variables, quantitative research is able to establish conclusions that are statistically significant. Assuming that the variables are identical then if the research was repeated under similar conditions it would arrive at identical findings and conclusions. Thus, deductive research provides conclusions that display high statistical reliability.

By contrast, qualitative research is subjective in nature. It views social reality as being within the values, feelings and impressions of individuals and therefore subjective in essence. It seeks data that is impressionistic, individualistic, and subjective in which personal bias is recognized as integral to individual viewpoints, perceptions motives and actions. Qualitative research is essentially handling animate intangibles and its data is expressed in non-numeric formats.

It involves non-numerical data such as words, observations and personal experiences. Qualitative research will involve subjective observation of phenomenon in their natural setting, without intervention or manipulation by the researcher. However,

researchers are often participants in, or observers of, the research process, and so potential issues of bias have to be acknowledged and explained.

Research that is undertaken as qualitative enquiry will display high validity for its findings that then have low reliability since statistical analysis of data will be low or absent. For these reasons, it is not possible to generalize from the conclusions in qualitative investigations since the research situation and its associated circumstances cannot be replicated. However, the conclusions will permit theory to be developed though propositions which others can test in their respective settings.

Bryman (2004: 19-20) distinguishes between these two research approaches by pointing out that quantitative research is deductive and so tests theories while qualitative research is inductive and so builds and develops theories. A third research approach combines these two epistemological positions. Research may need to adopt more than one research method to collect data in the field that necessitates using both deductive and inductive approaches. This approach is referred to as a mixed methodology which ‘... supports the integration of different elements in the research process to ensure the effective and successful study of phenomena. (Plowright, 2011: 3). The features of such investigations are defined as ‘.... research in which the investigator collects and analyzes data, integrates the findings and draws inferences using both qualitative and quantitative approaches or methods in a single study or programme of inquiry.’ (Tashakkori and Creswell, 2007: 3) Mixed methodologies can either test or develop theory.

### **The choice of methodology for my research**

In selecting my research methodology I considered the aim of my research as well as my research paradigm. The selection of my research approach was based on the following considerations and reasoning. The aim of my research was to explore the relationship between social responsibility and financial performance of companies in Israel. I sought evidence to show that social responsibility may have a positive impact on financial performance. Theories and models about such impact that corporate social responsibility has on their financial performance existed already. Thus, my research was not looking to construct a theory. Instead, it was testing the

relevance of an existing theory within the specific business and culture environment of Israel. Therefore I concluded that my research methodology would be deductive.

In selecting a hypothesis-testing deductive research approach, generalisable outcomes from my research could be provided. Such generalization would again serve the aim of the research to make the finding applicable to industry in Israel. Furthermore, my selection of research methodology had to consider the appropriateness of quantitative or qualitative approach. Again, I reached the same conclusion. First, my research paradigm, as explained earlier, was positivistic. This meant that reality was considered to be objective, and knowledge about such reality is accurate and can be measured. This philosophical view directed me towards a quantitative approach for the research, through which numerical data can be collected and analysed.

Having chosen a positivistic approach which assumes an objective reality, the research sought empirical information for the variables of corporate social responsibility and corporate financial performance. Therefore my fieldwork had to collect data that would satisfy the conditions of objectivity, finiteness, completeness and measurability. These data would then enable me to test the hypotheses from which conclusions could be drawn as to their appropriateness as assumed explanations of the real world (Bryman, 2004: 8). This meant that reality was considered to be objective, and that knowledge about such reality is accurate and can be measured. This philosophical view yields a quantitative approach for the research, through which numerical data can be collected and analysed.

Second, turning again to the aim of the research, the goal was to provide hard fact evidence to managers that were not early adopters, according to Roger's (1983) 'diffusion of innovation,' but rather the more skeptical 'late majority'. With this in mind, my research had to generate hard fact numbers that provided proof to business minded managers whose business models were intended to maximize profits. Thus, a quantitative research approach was an appropriate way to fulfill this research goal.

Accordingly, based on the research goal and paradigm, the deductive and quantitative approach was chosen and this determined how my research was designed and conducted.

The theory that is tested is a middle-range in nature, in that it focused on the specific explanation of observed regularities, and did not operate at either a general or an abstract level as grand theories (Bryman, 2004: 5). My theoretical perspectives were that two opposing forces drove the relationship between social responsibility and financial performance – costs and benefits of social responsibility. As a result, financial performance were assumed to be positively correlated with increased social responsibility, until reaching a certain maximal point from which on financial performance decrease with further increase in social responsibility.

Stemming from this theory, two hypotheses were formulated in the previous chapter, which was drawing on the literature review, as:

Hypothesis 1:  $H_0$ : The CFP does not increase as the level of CSP increases

$H_1$ : The CFP increases as the level of CSP increases

Hypothesis 2:  $H_0$ : There is no peak point beyond which CFP decreases as the level of CSP increases

$H_1$ : There is a peak point beyond which CFP decreases as the level of CSP increases

Those hypotheses provide also the boundary for the inquiry as the relationship between CSP and CFP.

### **Cross-Sectional Research**

Collis and Hussey (2003: 61) state that "Cross-sectional studies are a positivistic methodology designed to obtain information on variables in different contexts, but at the same time". In this study, specific corporations were selected for study to ascertain how the financial performances differed in relation to their social responsibility. Statistical tests were conducted to test whether there were correlations between social and financial performance.

In a cross-sectional study the data collected refers to the same single time period as a snapshot of an on-going situation. The variables of CSR and CFP were then examined to detect patterns of association. In this form of research, each company that was examined is referred to as a case.

This research, which complies with the definition of a cross-sectional research design, can be depicted in a rectangular table holding the data on CSP and CFP variables referring to a series of companies (cases) in Israel. For each company in the chosen sample the research will be collect two data items – CSP and CFP. This is illustrated in Table 6-1. In this table, companies 1 to n represent the sample of companies in this research. The other two columns represent the CSP and CFP data that will be collected for each company. This data representation of a cross—sectional design is denoted by Bryman (2004: 45) as 'data rectangular'.

	CSP Data Set	CFP Data Set
Company 1		
Company 2		
Company 3		
...		
Company n		

**Table 6-1 The data rectangular of the cross-sectional research (Bryman, 2004)**

By choosing a cross-sectional research design, the main elements of this research design included:

*Multiple cases:* Multiple cases in this research have the meaning of multiple companies. The research was interested in variations in the variables of CSP and CFP across multiple companies (cases) that comprised the larger sample.

*Single time periods:* The data on the variables of CSP and CFP for all the cases (companies) was collected for a single time. In this research the data about the companies was collected with regard to their performance during the calendar year of 2006.

*Quantitative data:* This cross-sectional research used quantitative data about the variables of CSP and CFP of the sampled companies. The quantification of the data provided also for a systematic and standardized method for gauging variation between companies (cases), and provided this research with a consistent benchmark.

*Patters of association:* The cross-sectional research design enabled relationships between the variables of CSP and CFP to be examined.

The design was done while considering also the frameworks that Rose (1982) had advanced for evaluating research, and that was used later on to interpret my research.

## **Methods**

The research involved two variables CSP and CFP. Planning this research required these concepts to be operationalised, deciding on the sample size and modes of data collection.

Concepts may be defined as building blocks of theory and represent the points around which research is conducted (Bryman, 2004: 65). Furthermore, a concept that is to be employed in quantitative research has to be measurable. In order to measure the concepts of CSP and CFP the research had to decide on an operational definition or make operationalisation of it (Bryman, 2004: 66). The literature revealed that those concepts had been interpreted in different ways through extant research. Thus, it was necessary to define how to operationalise the two concepts in this research.

Bryman (2004: 66-67) suggests that if a concept cannot be measured directly it can be measured through indicators. Indicators are something that are devised or already exists and that is employed as though it were a measure of the concept (Bryman, 2004: 67). Thus, an indicator can be viewed as an indirect measure of a concept. This approach was used to define CSP and CFP.

### *Operationalisation of Corporate Social Responsibility*

The concept of social responsibility cannot be measured directly and thus it had to be measured through indicators derived from the operationalisation of the concept. The measurement of social responsibility in previous research was based on four distinctive methods which were:

- Corporate Disclosure-Based data - qualitative text-based reports;
- Corporate Disclosure-Based data - quantitative numerical-based reports;
- External Evaluation, Survey-Based Subjective Measures;
- External Evaluation-Based Measures.



With the first three methods suffering from various actual or potential limitations in its objectivity, the external evaluation-based ranking was found to provide a reliable measure of social responsibility. It was used for the operationalisation and measurement of corporate social responsibility in this research.

The strength of this method depends on two principles. Firstly, it is based on multi-dimensional evaluation of social responsibility toward the various stakeholder groups of the firm. This is achieved by measuring a set of indicators, which are then aggregated to a single weighted index. Secondly, this method uses multiple sources and procedures to collect comprehensive data. This provides the advantage of triangulation for each of the measured indicators, yielding high reliability of the results.

#### *Operationalisation of Corporate Financial Performance*

It has been shown that corporate financial performance can be measured through accounting-based and market-based indicators. The former reflect past performance while the latter reflect estimation of future financial performance. Moreover, researchers recommended using multiple-indicator measure for this concept since a single indicator would not necessarily be sufficient to provide a reliable measure of a concept. This validated practice that was used by other researchers was followed in my research.

Drawing on this understanding, the concept of corporate financial performance has been operationalised through the use of three indicators that represent accounting-based and market-based measures. Those include:

- Return-on-Equity (ROE); – an accounting-based measure,
- Return-on-Assets (ROA); – an accounting-based measure,
- Price-to-earning ratio (P/E). – a market-based measure.

Thus, for each case those three indicators formed the measurable quotients for financial performance.

## **Sample**

The definition of the sample was driven by four factors – target population, research design, availability of required data with regard to the research variables, and ethical considerations. These considerations and their end result are described hereafter.

First, the target population has been set to Israeli companies, as the research sought to investigate the relationship between social responsibility and financial performance for companies in Israel. This provided the general group out of which the sample would be defined.

Second, having chosen a cross-sectional research design is translated into having multiple cases, as opposed to a single case study (Collis and Hussey, 2003: 61; Bryman, 2004: 41-46). According to Collis and Hussey (2003: 61) and Bryman (2004: 41-46), a cross-sectional research design would commonly use a large number of cases, which are companies in this research. The large sample size will satisfy the need to examine and detect patterns of association in the analysis phase. Thus, to satisfy statistical requirements of such calculations, it was decided that a minimum of 30 companies should serve as the sample.

Thirdly, the choice of sample size had to accommodate the issue of availability of data with regard to both social and financial performance as well as considering any ethical issues that were appropriate to this research. Thus, the choice for this research would be companies whose financial trading and reported business figures were available in the public domain. Similar choice has been done for numerous studies that have been reviewed in the theoretical perspective. Selection of the companies that make up the TA-100 index assures a high level of publicly reliable data is available for those companies whose trading has reached a specified level. Thus, my choice of companies was pragmatic and determined by Stock Exchange factors of reputation and high level of auditing by independent parties.

Companies traded on any stock exchange are required to make their audited yearly financial statement available to the public, adhering to fair trading regulations. Thus, such companies were a candidate to serve the requirements of the sample. The review of past research, as provided in chapter 4 and its corresponding annexes, shows that it

was common to choose companies forming a main index of a stock exchange such as the S&P 500 in the United States and FTSE 100 in the United Kingdom. Such indexes are made up from the leading companies that are traded in the corresponding exchange in terms of total value. The Israeli equivalent would be the Tel-Aviv 100 (TA 100) index of the Tel Aviv Stock Exchange (TASE).

Not surprisingly, when considering the availability of social responsibility data, past research as well as this one, has arrived at a similar group of companies. The reason for this coincidence is embedded in the logic and process that is behind the social ranking process. As explained in chapter 4, the rationale to make the extensive and costly procedure of robust measuring social performance, is driven and financially supported by socially responsible investment (SRI) practices of the world major investment funds. These investment funds are interested in the social performance of the large companies, which form a legitimate target for possible investment. Thus, the social ranking companies focus their efforts in measuring the social performance of companies which form the major indexes such as the S&P 500 and FTSE 100. This holds true for the KLD firm which performs social ranking in the U.S. for the S&P 500 companies, as well as for the MAALA organisation which form social ranking for Israeli companies which are also traded under the TA-100 index.

The third consideration, described above, is strongly coupled with ethical consideration. Normally it would be very difficult, if not impossible, to receive the consent of companies to use their financial data for research. This would hold true unless the companies are already obliged for other reasons to make such data public domain. Thus, the selection of public companies traded in a stock exchange, also satisfies the ethical requirements.

The above consideration led me to use a basic sample of 100 companies in Israel which form the TA-100 index. When I conducted my research during 2007, the most recent available financial data for the TA-100 companies was for the year ended in 2006. While some of my financial measures were two-year indicators, I have used financial data related to the years 2005 and 2006.

In summary, this study is based on a sample of Israeli companies that meet the following criteria for the year of 2005 and 2006:

- the company was listed in the Tel Aviv Stock Exchange TA-100 index of the top 100 companies in Israel for 2005 and 2006; and the firms' financial performance was available accordingly,
- the company was listed in the MAALA ranking of Corporate Social Responsibility Index for 2006,

The number of cases selected for my research was based on availability of financial data for the TA-100 index companies, and the availability of social responsibility ranking by MAALA. The exact number of cases and how I arrived at them is detailed later in this chapter.

### **Ethics Consideration**

Ethics consideration was met by this research through its design and data sources. The subject of the research dealt with companies as trading entities rather than human beings thus data that comprised my fieldwork was documentary in form and only I was involved in its collection and analysis. Throughout my research there was no risk of inflicting harm on humans. No permissions were required in order for me to assess the data and so there were no potential ethical hurdles to anticipate or handle. The research did not disclose any confidential data about the companies that were investigated. As a result, no issues of confidentiality arose or needed attention. Accordingly, the research design was approved by the University Ethics Committee.

### **Data Access and Collection**

All of the data related to the variables of CSR, or CSP; and CFP was collected from two public domain resources.

- Corporate Financial Performance: Tel Aviv Stock Exchange public domain database, including Tel Aviv 100 index for 100 leading companies in Israel, their financial performance and additional data that traded public companies are obliged to publish.
- Corporate Social Responsibility: MAALA public domain database, including CSR ranking for leading Israeli companies. As part of their membership with

MAALA, corporations agree to be rated on their social responsibility as well as publication of their social responsibility rating.

Following a positivistic strategy for the investigation, the testing of the hypotheses implied the accumulation of raw data that was numeric, objective and directly related to the variables that were to be tested as a relationship between CSR and CFP. The data that met these methodological requirements and which I required was in the public domain. Corporate financial data was available on the web site of the Tel Aviv Stock Exchange (TASE) and CSR ranking was available on the web site of MAALA association of 'Business for social responsibility in Israel'.

The TA-100 Index is one of the TASE's leading indices, published from 1992. The index consists of the 100 shares with the highest market capitalization (in Israel). All the companies are registered in Israel, and thus regarded Israeli companies. Financial data was openly available for 100 companies in the TA-100. For some companies there has been a peculiar change between these two years in financial data, which makes the data non-comparable between those two years, and can cause irregularity that create distortion in calculations of the financial performance. Reasons for such irregularities of data between the two years include:

- Companies that were excluded from the TA-100 index, or been added – no comparison can be made between the years,
- Change in system of financial reporting – causes changes in the measures of financial performance between the years,
- Stock Dilution – causes changes in the measures of financial performance between the years,
- Mergers and Acquisitions of companies – causes changes in the measures of financial performance between the years,

Accordingly, the list of TA-100 companies was analyzed for internal consistency for the reasons described above, for the two years of 2005 and 2006. All the irregularities were identified by official company disclosure notifications to the TASE authority. After taking out 16 companies with irregularities the sample size was adjusted to include 84 companies out of the 100 companies composing the TA-100 index. This is shown in Table 6-2 (101).

Category	Number
Total number of companies in the TA-100 index	100
Number of companies taken out because of irregularities	16
Number of remaining companies which make up the sample size of my research	84

**Table 6-2 Total number of companies in the sample of my research**

### **Number of Cases in Each Group of CSR**

The total number of companies in my research was 84 companies, all belonging to the TA-100 index. Out of these 84 companies, 21 have been ranked by MAALA as having medium (13) or high (8) level of CSR. Accordingly, the 84 companies are divided into CSR groups as shown in Table 6-3.

CSR Category	Number
Number of companies with high CSR	8
Number of companies with medium CSR	13
Number of companies with low CSR	63
Total number of companies (sample size)	84

**Table 6-3 Number of companies in each CSR category**

The collection of this data was undertaken electronically by downloading directly onto my personal computer from the TASE and MAALA websites during April 2007. Financial data of TA-100 companies is audited and approved to the highest standard according to the regulations of the TASE. Social responsibility data collected and calculated by MAALA, is audited by Ernst and Young's local office in Israel. It took me approximately 100 hours to select, download and allocate to sub-directories over a one-month period. No expenditure costs were incurred in this task and nobody else was involved in this process other than me. The data was stored on my computer for ease of access throughout this research. No technical difficulties were encountered or experienced in this data collection process.

All the downloaded data was in numeric form and located in EXCEL files. During the downloading I only accessed files relevant to the 84 companies that constituted my sample. Before these data were placed on their respective public lists they had been professionally audited by Ernst and Young (Israel) which provided an assurance of legitimacy and accuracy for its public use that I accepted. Thus, I had collected macro data that represented what Easterby-Smith, Thorpe and Lowe (1991: 118) argued constituted ‘... good material for the quantitative researcher.’

### **Type of Data**

The research used secondary data for the concepts of CSP and CFP. Secondary data is defined as data collected by others (Bryman, 2004: 200). The main reason for using secondary data is to access high quality data, which otherwise would not be matched due to constraints of cost or time. This is particularly true for measuring CSP, which would have required extensive effort. Past research on the issue of the relationship between CSP and CFP has used similar social ranking data provided by ranking firms such as KLD Inc. in the United States. As far as for the CFP, this had to rely on audited financial data published by the companies, and thus, is a secondary data by its nature.

Due to the use of secondary data, this research has benefited from the advantages of such data as suggested by Bryman (2004: 202-205), specifically the following:

- **Quality of data:** The use of social ranking data provided by a ranking firm resulted in the use of 'External Evaluation-Based Measures' gauged along multiple dimensions with regard to stakeholders, using multiple measuring tools. As reviewed in the theoretical perspective, this provides a good measure of corporate social responsibility in terms of accuracy and reliability. Additionally, the process and procedures of secondary data collection results in less respondent bias that might be since being open and public it is easily checked and verifiable.
- **Sample Size:** The considerable investment by social ranking firms, in collecting CSP data, enables them to probe a large sample. Such a sample size, and high quality of collected data, would be beyond the capacity of an

individual researcher. Thus, by using secondary data sources researchers are able to access larger sample sizes and this translates to greater reliability of the subsequent findings.

- Time: The social ranking of the data in this research was an output of the ranking firm. Such efforts, amounting to thousands of man-hours, provide results within a few months, which would be beyond the capability of individual researchers or small teams of researchers.

### **Source for CSR Data**

This research used CSP data published by the social ranking organization in Israel. MAALA - 'Business for Social Responsibility in Israel' - is a non-profit organization, founded in September 1998, to promote the concepts of corporate citizenship and social responsibility in Israel's business arena. MAALA profile is provided in Appendix 6-1.

MAALA produced the first CSR ranking in 2004 and the ranking for 2006 was significantly improved from that of the two previous years. Companies were expected to provide more data and higher transparency as far as social responsibility was concerned. The 2006 ranking was based on expanded criteria in four main topics of corporate social responsibility: Business Ethics, Workplace and Human Rights, Community Investment, and Environment. The updated criteria had been jointly prepared by the MAALA public committee of experts, and McKinsey and Co. The ranking process has been conducted by the *Maalot* rating company (a *Standard and Poor's* affiliate in Israel) and audited by *Ernst and Young* auditory and advisory firm. Data for the Index was collected annually via corporate questionnaires, financial statements and information reviewed by an environmental analyst. The criteria have been developed to take into account the high level of international standards related to corporate responsibility, as well as the local business market in Israel.

MAALA is responsible also for the formulation and publication of the 'MAALA CSR Ranking' and the 'MAALA Index for Social Responsibility'. The 'MAALA Index for Social Responsibility', first introduced in 2003, was launched on the Tel Aviv Stock Exchange in 2005. It rates the largest public and private companies in Israel and



includes companies in the Tel Aviv 100 Index or those with an annual profit greater than \$100 million.

The social measures of performance were collected from MAALA ranking of CSR of Israeli corporations. The MAALA ranking of CSR is equivalent to that of Kinder, Lydenberg, Domini (KLD) in the United States. While the KLD rates the companies across the entire Standard and Poor's 500, the MAALA only ranks Israeli companies which belong to the Tel Aviv 100 index.

The CSP index was based on a multi-dimensional construct. Companies were scored according to performance in four main dimensions or categories. Scores for each dimension are based on measurable indicators. In certain instances, scores are weighed according to company size, sector, profit earnings, or relative performance. A scoring system of 100 points is applied to all company returns. Categories/Dimensions of the CSP index, and their respective indicators, include:

- 1 *Business Ethics* (25 points), based on the following indicators: Code of Ethics (11 points) and internal system for implementing Code of Ethics (14 points).
- 2 *Workplace and Human Rights* (25 points), based on the following indicators: Human Rights (10 points), and Workplace (15 points).
- 3 *Community Investment* (25 points), based on the following indicators: Philanthropy (15 points), Investment Policy (5 points), and Employee Volunteering (5 points).
- 4 *Environment* (25 points), based on the following indicators: Policies (2.5 points), Management and Implementation (7.5 points), Environmental Performance (10 points), and Reporting (5 points).

Further details about MAALA ranking methodology and Scoring System are provided in Appendix 6-2 and 6-3 respectively.

The CSP data for the companies in the sample is provided in Appendix 6-4.

### **Source for CFP Data**

The data regarding CFP is extracted from the audited financial statement of the companies. The sample of companies is based on companies belonging to the Tel Aviv 100 index (TA-100) in the Tel Aviv Stock Exchange (TASE). The TA-100

Index is one of the TASE's leading indices. The index consists of the 100 stocks with the highest market capitalization that are included in the TA-25 and TA-75 indices. Overall Market Cap of TA-100, dated 29/03/2007, is 541,973,652 NIS thousands. Currently, this figure was approximately equivalent to 130 Billions \$US.

Two measures of financial performance (FP) that are generally considered to capture major dimensions of financial performance utilized: ROA and ROE. However, this study has used three indicators of financial performance, calculated over the two-year period of 2005-2006. Thus, measures of financial performance were as follows:

- Two year ROA: average ROA calculated over a two-year period;
- Two year ROE: average ROE calculated over a two-year period;
- P/E ratio: average Price-to-Earning Ratio calculated over a two-year period.

The CFP data for the companies in the sample is provided in Appendix 6-5.

In addition to the financial data, the industry sector of each company was extracted as well from the TASE data base. The TASE defines, for each company in the TA-100 index, the industry sector according to the following categories: Investment & Holdings, Real-estate & Construction, Commerce & Services, Industry, Oil & Gas Exploration, Insurance, Banks. This data served to test whether the relationship between corporate social responsibility and financial performance was industry dependent, as suggested by Griffin and Mahon (1997).

## **Chapter Summary**

This chapter has explained the research design which is driven by positivistic paradigm, and follows the methodology of a quantitative and deductive research. It has shown that in order to test the research hypotheses the research sought empirical data about social and financial performance of companies in Israel. The sample of companies has been defined as well as the type of data to be collected and the methods to collect that data. It has justified the use of secondary data and the solidity of their respective sources. This data will serve for the fieldwork as reported in the next chapter.

## Chapter 7 Findings

### Introduction

This chapter presents the findings from the investigation and applies them to the hypotheses. The findings provide the foundation from which to draw conclusions regarding the proof or refutation of the hypotheses.

### Testing of the First Hypothesis

The first hypothesis was stated as:

**H1:** A group of companies with high CSP would be found to have better financial performance than their counterparts with low CSP.

This hypothesis was tested in context to companies in Israel. This test was based on comparison between two groups of companies those with high and low CSR as measured by CSP. The group with high CSR was based on social responsibility ranking in Israel published by MAALA association. This high CSR group was denoted logically as 'High CSR' (H). The second group included leading Israeli companies that are assumed to have low CSR, as they are not included in the social ranking in Israel. This low CSR group was denoted as 'Low CSR' (L).

Exploratory data analysis (EDA) was used to test the hypothesis for comparing the two groups of companies. The test applied a method of average ranking differentiation between the two groups of companies. This test design duplicated a similar methodology applied by Verschoor (2001) and Webley and More (2003). This testing method was implemented in the following steps:

- The measure of financial performance was calculated for each company. This was done for several measures of financial performances;
- The 84 companies of the sample (84) were assigned a rank number, according to their calculated financial performance.
- Average rank was calculated for the companies in each group (low and high CSR).

- The difference between the average rankings of the two groups was calculated. This result is given in a table and graphical representation.

The average ranking differentiation method was selected because the two groups of companies were not matched in many ways, including the number of companies in each group, and their nature in terms of industry sector as well as other commercial parameters.

Financial performance included the two-year average of ROE and ROA and the two-year average of P/E.. The above test uses data from companies belonging to various industry sectors, thus it is a cross-industry test. The test was repeated for separate industry sectors to explore whether this factor has any significant affect on the hypothesis.

#### *Companies*

The companies for the two groups (CSR=H, CSR=L) are taken from the TA-100 index, as shown in Table 7-1:107-108.

Name	CSR	Sector	Name	CSR	Sector	Name	CSR	Sector
<i>Africa</i>	L	1	<i>Elco Holdings</i>	L	1	<i>M.A. Industries</i>	L	4
<i>Africa Pro</i>	L	2	<i>Electra</i>	L	1	<i>Matrix</i>	L	3
<i>Africa Res</i>	L	2	<i>Electra RE</i>	L	2	<i>Melisron</i>	L	2
<i>Airport City</i>	L	2	<i>Elron</i>	L	4	<i>Menorah Mivtac</i>	L	6
<i>Alony Hetz</i>	H	2	<i>Excellence</i>	L	3	<i>Migdal Ins.</i>	L	6
<i>Alrov</i>	H	2	<i>Fibi</i>	L	7	<i>Mivtach Shamir</i>	H	1
<i>Amot</i>	L	2	<i>FMS</i>	L	4	<i>Mizrahi Tefahot</i>	L	7
<i>Arazim</i>	L	2	<i>Formula</i>	L	3	<i>Nice</i>	L	4
<i>Audiocodes</i>	L	4	<i>Frutarom</i>	L	4	<i>OHH</i>	L	7
<i>Avner</i>	L	5	<i>Gazit</i>	L	2	<i>Ormat</i>	H	4
<i>Azorim</i>	L	2	<i>Gazit globe</i>	H	2	<i>Osem</i>	H	4
<i>Bayside Land</i>	H	2	<i>Gilat</i>	L	4	<i>Paper mills</i>	L	4

Name	CSR	Sector	Name	CSR	Sector	Name	CSR	Sector
<i>Bezeq</i>	L	3	<i>Granite</i>	L	3	<i>Partner</i>	H	3
<i>Blue Sq. RE</i>	L	2	<i>GTC</i>	L	2	<i>Phoenix I</i>	L	6
<i>Blue Sq. IL</i>	H	3	<i>Harel</i>	H	6	<i>Plasson Ind.</i>	H	4
<i>Blue Sq. pro</i>	L	3	<i>Housing and Construction</i>	L	2	<i>Poalim</i>	H	7
<i>Camtek</i>	L	4	<i>ICL</i>	L	4	<i>Property and Building</i>	L	2
<i>Clal industries</i>	L	4	<i>IDB dev</i>	L	1	<i>Radvision</i>	L	4
<i>Clal insurance</i>	H	6	<i>IDB Holdings</i>	L	1	<i>Radware</i>	L	3
<i>Darban</i>	L	2	<i>Indus Building</i>	H	2	<i>Retalix</i>	L	3
<i>Delek Auto</i>	L	3	<i>International 5</i>	L	7	<i>Salt</i>	L	1
<i>Delek Drill</i>	L	5	<i>Israel Corp.</i>	L	1	<i>Scailex</i>	L	1
<i>Delek RE</i>	L	2	<i>Ituran</i>	H	3	<i>Scope</i>	L	3
<i>Direct Ins.</i>	L	6	<i>Jerusalem Eco</i>	H	2	<i>Strauss Group</i>	H	4
<i>Discount</i>	H	7	<i>Kardan Israel</i>	L	1	<i>Supersol</i>	L	3
<i>Discount inv</i>	L	1	<i>Kardan n.v.</i>	L	1	<i>Tadiran Com.</i>	H	4
<i>Ds Apex</i>	L	3	<i>Koor</i>	L	4	<i>Tefron</i>	L	4
<i>Elbit System</i>	H	4	<i>Leumi</i>	H	7	<i>Union</i>	L	7

**Table 7-1 List of Companies and Grouping**

Industry Sector: The TA-100 companies were classified according to an industry sector of their business. Industry sectors and codes are shown in Table 7-2.

Sector code	Industry Sector	Sector code	Industry Sector
1	Investment and Holdings	5	<i>Oil and Gas Exploration</i>
2	Real-estate and Construction	6	<i>Insurance</i>
3	Commerce and Services	7	<i>Banks</i>
4	<i>Industry</i>	0	<i>All sectors together</i>

**Table 7-2 Industry Sector**

### Results of Testing for the First Hypothesis

The comparison between the two groups of companies displaying low and high CSR, shows that companies with high CSR has better financial performance than those with

low CSR. The three financial measures were tested separately, and the results are shown in Table 7-3.

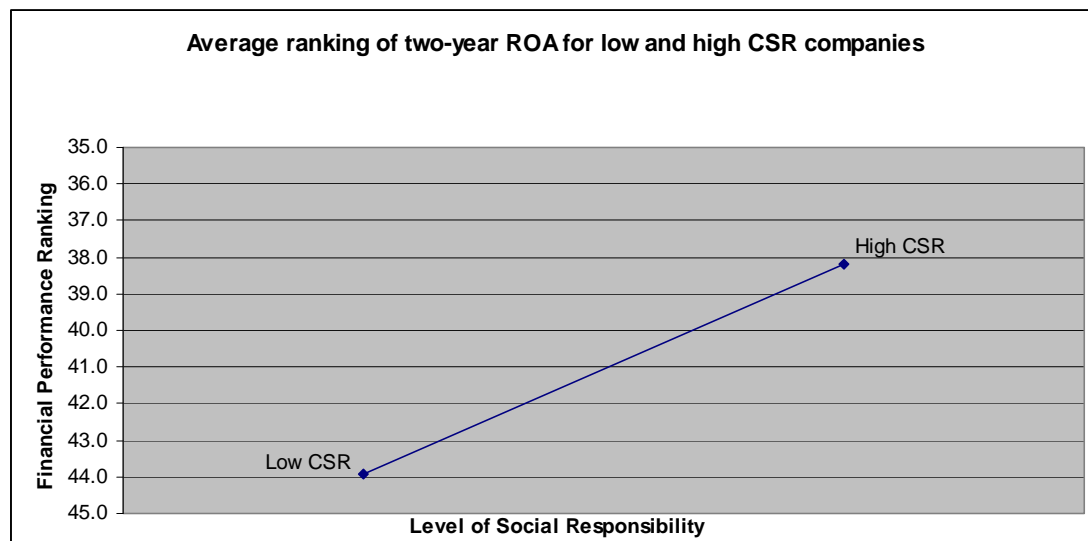
[Industry Sector = All]	ROA	ROE	P/E	<i>Yield</i> <i>[1/(P/E)]</i>
Average rank of financial performance for companies with high CSR (CSR = 1)	38.2	32.9	49.0	35.0
Average rank of financial performance for companies with low CSR (CSR = 0)	42.5	45.7	40.3	43.7
<i>Percentile of better average ranking of financial performance of CSR=1 relative to CSR=0</i>	<b>6.8%</b>	<b>15.3%</b>	<b>-10.2%</b>	<b>8.6%</b>

**Table 7-3 Results of comparison of financial performance between two groups of companies – low and high CSR**

The following observations can be offered on these findings:

*Testing of two-year ROA:*

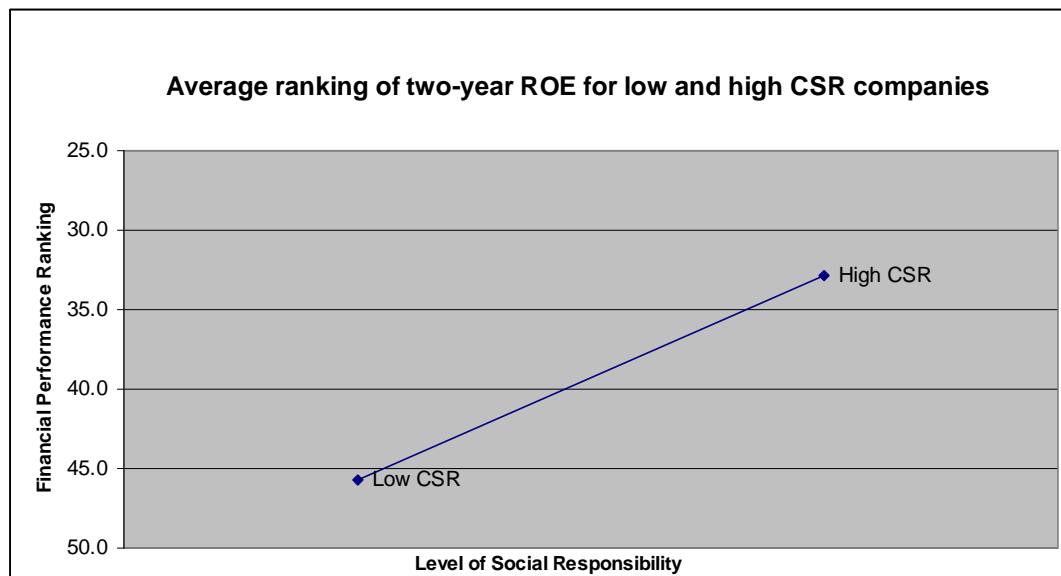
The mean percentile ranking of the high CSR group was around 6.8 percentile points higher than the mean ranking of the low CSR group. This is shown in Figure 7-1.



**Figure 7-1 Average ranking of two-year ROA for low and high CSR companies**

*Testing of two-year ROE:*

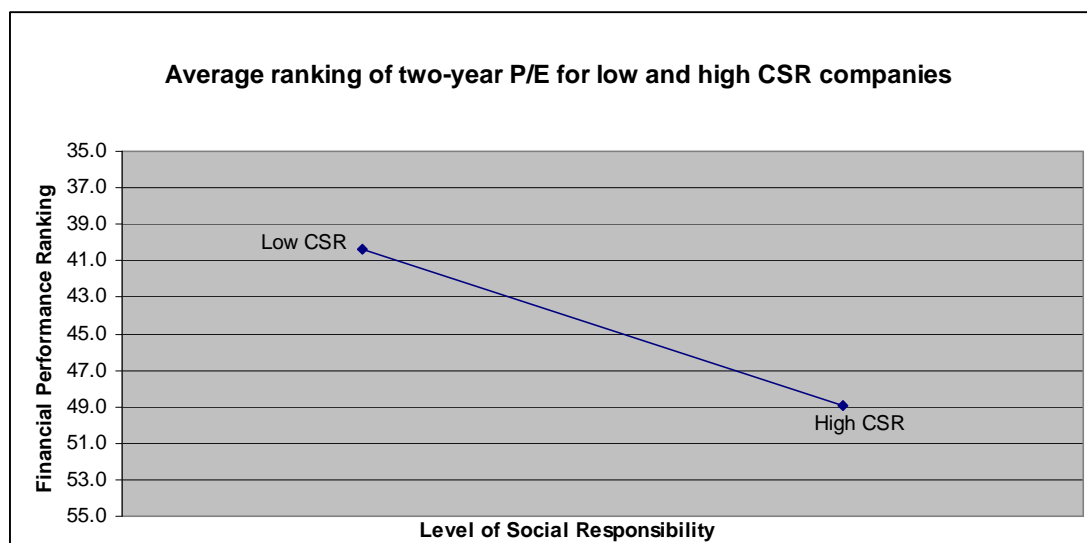
The two-year ROE is an accounting-based measure of financial performance. The mean percentile ranking of the high CSR group was around 15.3 percentile points higher than the mean ranking of the low-CSR group. This is shown in Figure 7-2.



**Figure 7-2 Average ranking of two-year ROE for low and high CSR companies**

*Testing of two-year P/E:*

The two-year P/E, is a market-based measure of financial performance. The mean percentile ranking of the high CSR group was around 10.2 percentile points lower than the mean ranking of the low CSR group. However, the two-year Yield (reciprocal P/E), the mean percentile ranking of the high CSR group was around 8.6 percentile points higher than the mean ranking of the low CSR group. This is shown in Figure 7-3.



**Figure 7-3 Average ranking of two-year P/E for low and high CSR companies**

Thus, in three out of four measures of financial performance, those findings support the hypothesis that a group of companies of high social responsibility have better financial performance than a group of companies having low social responsibility. Only the P/E ratio did not conform to those finding. However, this is in-line with past research suggesting that market-based financial measures are less representative of the actual financial performance as they are forward looking in nature (Griffin and Mahon, 1997).

The same test was repeated separately for each industry sector to investigate the effect of industry on the relationship between corporate social and financial performance. For the purpose of such testing the original two groups of companies, with high and low CSR, were separated each into sub group according to their industry sector. However, the resulting sub-groups included small sample for each, which accounts for low statistical significance. Moreover, the test could not be applied to the industry sector number 5 (Oil and Gas Exploration) as there were no high CSR companies in this sector.

The results for all single industry comparison tests are shown in Table 7-4. The table runs according to each industry sector, and indicates the size of the two groups in each comparison. This is indicated in brackets next to the sector name, with the number of companies in the group of high-CSR first.

	Industry Sector	ROA	ROE	P/E
Percentile of better average ranking of CSR=1 relative to CSR=0	1) Investment and Holdings (1, 11)	50.0%	41%	-50%
	2) Real-estate and Construction (6, 15)	10.0%	9.0%	-8.0%
	3) Commerce and Services (3, 12)	30.6%	25.0%	-6.0%
	4) Industry (6, 14)	13.1%	37.0%	-25.0%
	5) Oil and Gas Exploration (0, 2)	NA	NA	NA
	6) Insurance (2, 4)	25.0%	0.0%	-13.0%
	7) Banks (3, 5)	23.3%	10.0%	-37.0%

**Table 7-4 Results for single industry comparison tests**

Analysing the results in the table, the following can be observed:



- Overall, the results of the separate industry sectors support the hypothesis that the groups of companies with high social responsibility have better financial performance. This holds true for three financial indicators of ROA, ROE, and Yield.
- The size of the groups of high CSR is very small for most of the industry sectors. This can explain the differences in sector results, as well as account for low statistical significance of those results.
- Otherwise, single sector comparison did not provide additional insights.

### **Testing of the Second Hypothesis**

The research tested the second hypothesis which was:

**H2:** There is a peak point beyond which CFP decreases as the level of CSP increases.

This test was based on comparison between three groups of companies – these with low, medium and high CSR (denoted as L, M, H, respectively). This procedure of testing follows similar procedures of past research (Bowman and Hire, 1975; Sturdivant and Ginter, 1977). Bowman and Hire (1975) suggested dividing the data about the performance of companies into three categories according to the level of their social responsibility. This finer division allows for the identification of peak financial performance for the mid group, with the other two groups of lower and higher social responsibility having reduced average financial performance.

The companies in the sample were divided into three groups of low, medium, and high CSR. The sample of companies was identical to that in the first test and was divided into three groups according to their level of social responsibility, as following:

- Companies having low level of social responsibility, as defined previously in the first test. This included companies that were not included in the social ranking by MAALA.
- Companies with social responsibility level below 4.5 points according to the ranking by MAALA. Those companies form the medium CSR level group.
- Companies with social responsibility above 4.5 points according to the ranking by MAALA. Those companies form the high CSR level group.

The companies in each group are listed in Table 7-5.

Name	CSR	Name	CSR	Name	CSR
<i>Africa</i>	L	<i>Elco Holdings</i>	L	<i>M.A. Industries</i>	L
<i>Africa Pro</i>	L	<i>Electra</i>	L	<i>Matrix</i>	L
<i>Africa Res</i>	L	<i>Electra RE</i>	L	<i>Melisron</i>	L
<i>Airport City</i>	L	<i>Elron</i>	L	<i>Menorah Mivtac</i>	L
<i>Alony Hetz</i>	M	<i>Excellence</i>	L	<i>Migdal Ins.</i>	L
<i>Alrov</i>	M	<i>Fibi</i>	L	<i>Mivtach Shamir</i>	M
<i>Amot</i>	L	<i>FMS</i>	L	<i>Mizrahi Tefahot</i>	L
<i>Arazim</i>	L	<i>Formula</i>	L	<i>Nice</i>	L
<i>Audiocodes</i>	L	<i>Frutarom</i>	L	<i>OHH</i>	L
<i>Avner</i>	L	<i>Gazit</i>	L	<i>Ormat</i>	H
<i>Azorim</i>	L	<i>Gazit globe</i>	M	<i>Osem</i>	H
<i>Bayside Land</i>	M	<i>Gilat</i>	L	<i>Paper mills</i>	L
<i>Bezeq</i>	L	<i>Granite</i>	L	<i>Partner</i>	M
<i>Blue Sq. RE</i>	L	<i>GTC</i>	L	<i>Phoenix 1</i>	L
<i>Blue Sq. IL</i>	M	<i>Harel</i>	M	<i>Plasson Ind.</i>	M
<i>Blue Sq. pro</i>	L	<i>Housing and Con</i>	L	<i>Poalim</i>	H
<i>Camtek</i>	L	<i>ICL</i>	L	<i>Propert and Build</i>	L
<i>Clal industries</i>	L	<i>IDB dev</i>	L	<i>Radvision</i>	L
<i>Clal insurance</i>	M	<i>IDB Holdings</i>	L	<i>Radware</i>	L
<i>Darban</i>	L	<i>Indus Building</i>	H	<i>Retalix</i>	L
<i>Delek Auto</i>	L	<i>International 5</i>	L	<i>Salt</i>	L
<i>Delek Drilling</i>	L	<i>Israel Corp.</i>	L	<i>Scailex</i>	L
<i>Delek RE</i>	L	<i>Ituran</i>	M	<i>Scope</i>	L
<i>Direct Ins.</i>	L	<i>Jerusalem Eco</i>	M	<i>Strauss Group</i>	H
<i>Discount</i>	H	<i>Kardan Israel</i>	L	<i>Supersol</i>	L
<i>Discount inv</i>	L	<i>Kardan n.v.</i>	L	<i>Tadiran Com.</i>	M
<i>Ds Apex</i>	L	<i>Koor</i>	L	<i>Tefron</i>	L
<i>Elbit Systems</i>	H	<i>Leumi</i>	H	<i>Union</i>	L

**Table 7-5 List of Companies and Grouping (CSR=L, CSR=M, CSR=H)**

Legend:

CSR=L: Companies having low CSR (63 companies)

CSR=M: Companies having medium CSR (13 companies)

CSR=H: Companies having high CSR (8 companies)

### Results of Testing for the Second Hypothesis

The comparison between the three groups of companies with low, medium and high CSR show overall ‘better’ financial performance for companies with medium social responsibility. The three financial measures were tested separately, and the results are shown in Table 7-6.

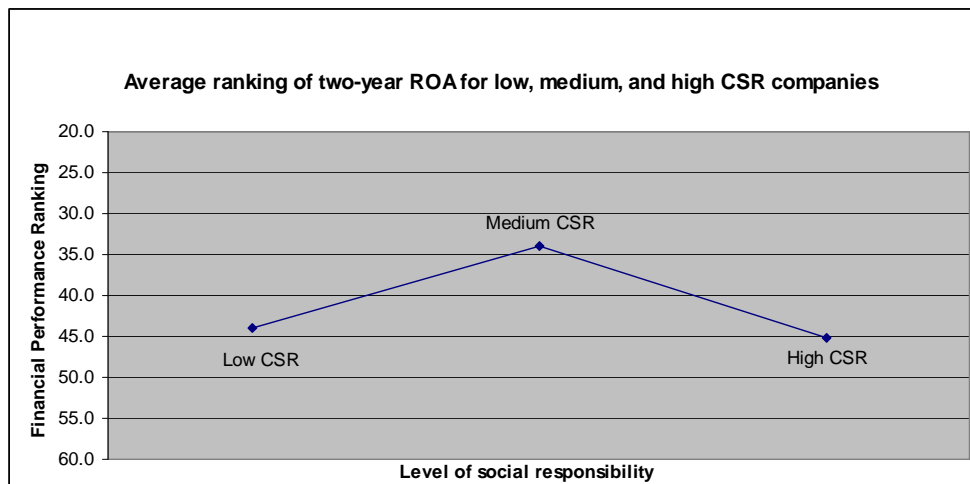
	<b>ROA</b>	<b>ROE</b>	<b>P/E</b>
Average rank of financial performance for companies with low CSR (CSR = <b>L</b> )	43.9	45.7	40.3
Average rank of financial performance for companies with medium CSR (CSR = <b>M</b> )	33.9	28.4	46.8
Average rank of financial performance for companies with high CSR (CSR = <b>H</b> )	45.1	40.3	52.5

**Table 7-6 Results of comparison of financial performance between three groups of companies – low, medium and high CSR**

Analysing the results in the table, while considering the three different financial measures, the following can be observed:

#### *Two-year ROA:*

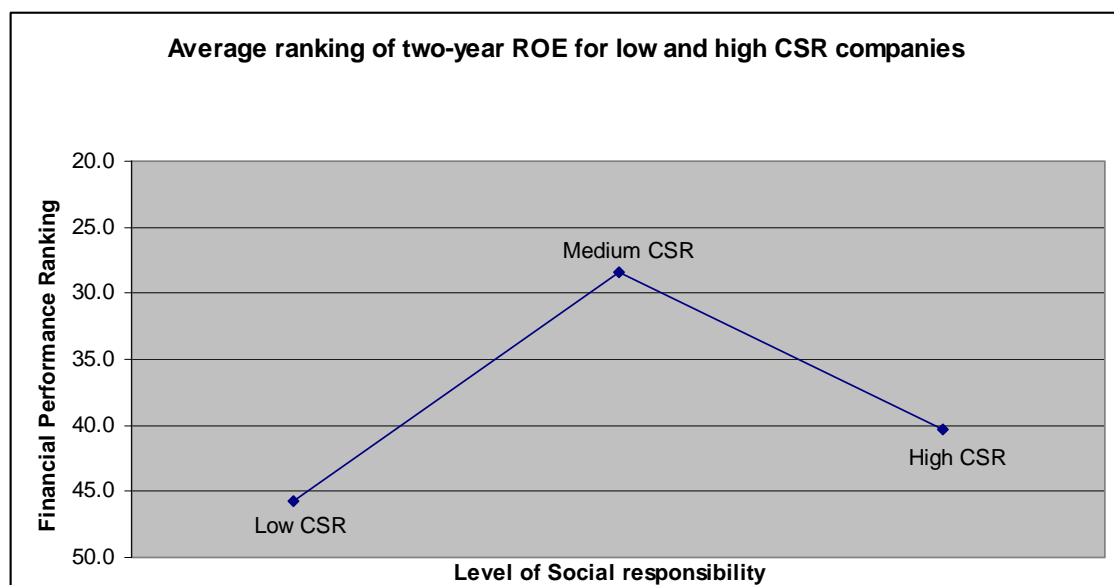
This is an accounting-based measure of financial performance. There was a peak in financial performance of the group of companies with medium level of social responsibility. The mean percentile ranking of the medium-CSR group was around 11.9 percentile points higher than the mean ranking of the low-CSR group. Similarly, the mean percentile ranking of the medium-CSR group was around 13.3 percentile points higher than the mean ranking of the high-CSR group. This is shown in Figure 7-4 (115).



**Figure 7-4 Average ranking of two-year ROA for low, medium, and high CSR companies**

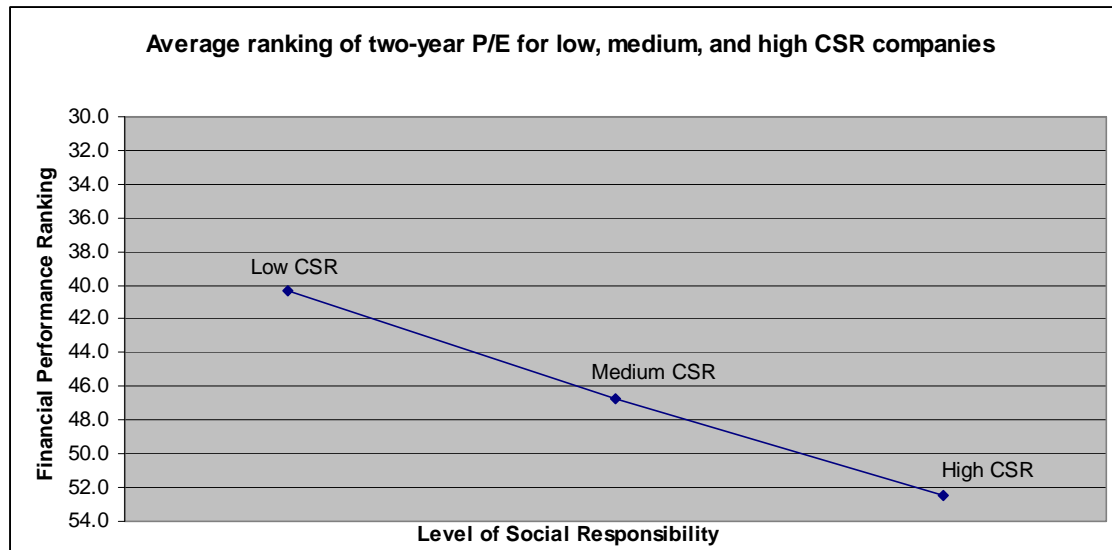
*Two-year ROE:*

This is also an accounting-based measure of financial performance. There was a peak in financial performance of the group of companies with medium level of social responsibility. The mean percentile ranking of the medium-CSR group was around 20.6 percentile points higher than the mean ranking of the low-CSR group. Similarly, the mean percentile ranking of the medium-CSR group was around 14.1 percentile points higher than the mean ranking of the high-CSR group. This is shown in Figure 7-5.



**Figure 7-5 Average ranking of two-year ROE for low, medium, and high CSR companies**

With regard to two-year-P/E, which is a market-based measure of financial performance; the results show monotonic increase in financial performance with increase in social responsibility. Thus, no peak point was found for the financial performance of companies with medium level of social responsibility. This is shown in Figure 7-6.



**Figure 7-6 Average ranking of two-year P/E for low, medium, and high CSR companies**

Thus, the findings with regard to the two accounting-based measures of financial performance, ROA and ROE, support the second hypothesis that there is a peak in financial performance for companies having medium level of financial performance. This means that there is a peak point beyond which CFP decreases as the level of CSP increases. Only the P/E ratio did not conform to those finding. However, this is in-line with past research suggesting that market-based financial measures are less representative of the actual financial performance as they are forward looking in nature (Griffin and Mahon, 1997).

The testing was not repeated separately for each industry sector, because the groups of medium and high CSR were very small with sometimes only one or two companies in a group. Thus, no significant finding can be expected with such small sample of single industry groups. Similarly, the testing was not conducted for a single component of social responsibility because such categorization led to very small groups which could not provide significant results.

### Testing the Influence of Company Size on CSR

This test investigated the possible influence of company size on the level of social responsibility for companies in Israel. According to the literature review, research has shown that there is a correlation between the level of CSP and the size of the company (Griffin and Mahon, 1997; More, 2001). The rationale given for that was that large companies have greater resources out of which they can use a larger amount of resources to CSR. Accordingly, the test might reveal a possible confounding factor which is company size. This might threaten the validity of inference that higher CSR is the cause for higher CFP.

Confirmatory data analysis was used for testing possible correlation between company size and total measure of CSP. The test was conducted only for the companies for which a detailed CSR score was provided by MAALA, thus 21 companies were included in the sample. The CSR score provide by MAALA is shown in Table 7-7, and regarded as ratio data. Company size was divided into three size categories based on the level of their total assets. Size categories are designated: 1=Small, 2=Medium, 3=Large; based on the following scale:

Small (1): Total assets less than 5 M NIS (M=Millions, NIS=New Israeli Shekel)

Medium (2): Total assets between 5 M NIS and 50 M NIS.

Large (3): Total assets more than 50 M NIS.

Company size and the level of social responsibility are provided in Table 7-7.

Name	CSP	Size	Name	CSP	Size
Elbit systems	6.0	2	Alrov	4.0	1
Strauss group	5.6	1	Clal insurance	3.9	2
Discount	5.4	3	Harel	3.8	2
Leumi	5.3	3	Ituran	3.7	1
Osem	5.3	1	Jerusalem econ	3.5	2
Indus building	5.0	2	Tadiran com.	3.2	1
Ormat	4.7	2	Alony hetz	3.0	1
Poalim	4.7	3	Plasson Industries	2.8	1
Partner	4.5	1	Bayside land	2.2	1
Blue square	4.4	1	Mivtach Shamir	2.0	1
Gazit globe	4.3	2			

**Table 7-7 Companies and their CSR scoring data and size - test cluster B**

The results of the correlations for firm size are presented in Table 7-8.

		<i>Size</i>	
	N	Pearson Correlation	<i>Sig. (2-t)</i>
<i>Total CSP</i>	21	.490*	.024

**Table 7-8 Testing for correlation between CSP and company size**

\* = Correlation is significant at the 0.05 level (2-tailed)

The results show a highly significant correlation of between the level of social responsibility (CSP) and company size. These results support past findings that the level of CSP is strongly correlated to company size (Griffin and Mahon, 1997; More, 2001).

### **Test Evaluation**

The first test cluster compared the financial performance of two groups of companies, with one having low level of social responsibility while the other group included companies with high level of social responsibility. The comparison of financial performance based on the indicators of ROA and ROE, showed that the group of companies with high social responsibility ranking had better financial performance than the group of companies of low social responsibility. Those finding support the first hypothesis that ‘Higher social responsibility can lead to improved financial performance.’

However, when this test was repeated while using the P/E indicator of financial performance, the results did not support the hypothesis. In this case companies with high social responsibility did not have a better price-to-earning ration than the group of companies with low social responsibility. In fact, the result has shown the opposite relations between the two groups.

The difference in findings, while using accounting-based or market-based measures of financial performance, is compatible with past research and conceptual understanding (Griffin and Mahon, 1997; Margolis and Walsh, 2001; Moore, 2001). Those scholars explained the difference in results by the fact that accounting-based measures of

financial performance actually reflect past performance and thus are best to be used by such kind of research. Contrary to this, market-based measures of financial performance reflect expectations for future earning which do not reflect the reality of past performance and therefore may distort the actual performance. It is therefore that Griffin and Mahon (1997) and others (Margolis and Walsh, 2001; Moore, 2001) recommended the use of accounting based measures of financial performance for this kind of research.

If we accept the recommendation to rely on accounting-based measures of financial performance, then the results of this research with regard to the financial indicators of ROA and ROE support the hypothesis that corporations with high social responsibility will generally outperform their counterparts with low social responsibility.

The second test cluster was aimed to test the second hypothesis that suggested that if companies will strive for extremely high social responsibility their financial performance will decline in comparison to other companies with medium level of financial performance. Thus, the hypothesis expected a curve with a peak level of financial performance for companies with medium level of social responsibility, as was found in past research (Bowman and Hire, 1975; Sturdivant and Ginter, 1977; Moore, 2001).

The test of this hypothesis was based on comparison of three groups of companies, with low, medium, and high level of social responsibility respectively. As in the first test, the second test was repeated for three measures of financial performance, and therefore is referred to as a cluster. The measures of financial performance included two accounting-based measures – ROA and ROE, and one market-based measure plus the Price-to-Earning Ratio (P/E).

The comparison of financial performance, between the three groups, based on the indicators of ROA and ROE, showed that the group of companies with medium social responsibility ranking had better financial performance than the two other groups which had either lower or higher level of social responsibility. This is similar to the finding reported Bowman and Hire (1975) and their explanation that "*Medium activity*



*in corporate responsibility is clearly more closely associated with high profitability than is either little or much activity" (1975:52).* Those findings support the second hypothesis that 'There is a peak point beyond which financial performance will decrease as the level of corporate social performance further increases.' This means that companies having medium level of social responsibility will have better financial performance than other companies with lower or higher level of social responsibility.

However, and similar to the finding of the first test cluster, when this test was repeated while using the P/E indicator of financial performance, the results did not support the hypothesis. In this case financial performance kept declining with social performance, not showing any change in higher levels of social responsibility. The reason that testing based on P/E ratio did not comply with the results when testing with ROA and ROE, is the same as given in the first test. That is that market-based measures of financial performance reflect expectations for future earning and do not capture the true value of past financial performance (Griffin and Mahon, 1997; Margolis and Walsh, 2001; Moore, 2001). Thus, if we follow the recommendation to relay on accounting-based measures of financial performance, the results of this research support the hypothesis that there is a peak in the relationship between CSP and CFP, beyond which further increase in social responsibility will result in negative impact on financial performance.

A third test was conducted with regard to the relationship between firm size and the level of its social responsibility. The results showed a positive correlation between firm size and the level of social responsibility. Larger firms tend to have a higher level of social responsibility. This result supports past findings that the level of CSP is strongly correlated with company size (Griffin and Mahon, 1997; More, 2001).

The various tests conducted with ROA and ROE as measures of financial performance confirmed the two hypothesis. Thus, Israeli companies that were included in this investigation displayed a relationship between corporate social performance and financial performance was non-linear and similar to research finding in leading western economies. It shows that financial performance increases with social responsibility, until a certain maximum is achieved, beyond which further increase in social responsibility resulted in decrease in financial performance.

**Chapter Summary**

The data from the fieldwork has been presented and categorized. These findings have been applied to the hypotheses as tests. Conclusions were drawn that confirmed both hypotheses. The next chapter provides interpretations of the research.

## **Chapter 8 Interpretation of the Research**

### **Introduction**

This chapter interprets the research. It presents the model that was used to interpret the finding and to assess the way in which the research was undertaken. It shows meanings that can be drawn out of the empirical data that was collected. It shows how consistency can be claimed for the design of, and findings from, this investigation.

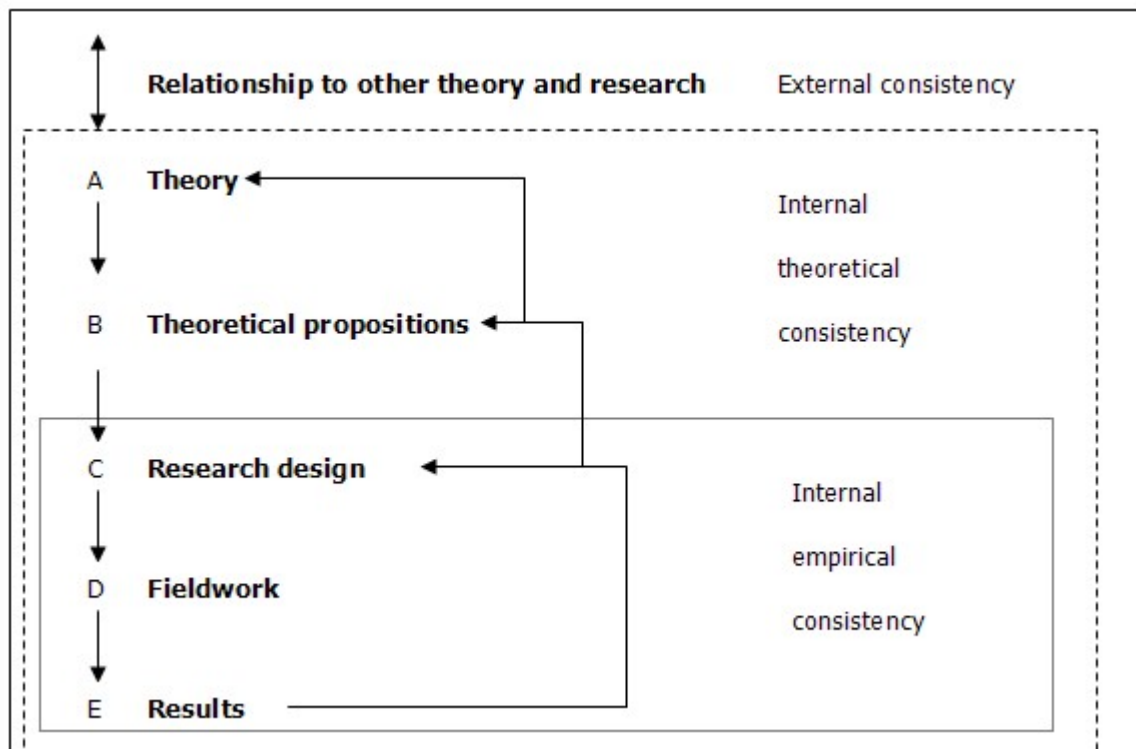
### **The Interpretive Approach**

I chose to use a model to interpret the data from the literature on research methodology in sociology. The reason for this is that Rose's model (1982:14÷20) was initially devised to assist sociologists in making sense of deductive investigations and the associated need to handle numeric data. Since my research was deductive, sequentially ordered, number-rich and sought to test theory, this model was considered to fit my research methodologically and philosophically.

The theory, by Rose (1982:14÷20), argues that serious research can be portrayed as having five interconnected components. The first component, A, links the research and external theories from which its theoretical positions, and the second component, B, includes the hypotheses that are informed by these theoretical perspectives. This gives rise to the third component, C, of operational decisions that are made to carry out empirical investigations. This component of the model includes the data collection techniques, sampling processes, implied concepts and indicators of meaning plus the variables. The fourth component, D, is the fieldwork. Finally, the fifth component, E, includes the findings and results.

Figure 8-1 (123) represent the model that Rose proposed. It shows the relationships between the five components ~ A, B, C, D and E ~ as interconnected by direct causal association. This accords with my view that was taken of both the research itself and the field as the investigation was designed. This approach to the interpretative process is that it emphasizes the importance of the links between research components. Rose saw that feedback from component E through to component A

permitted researchers to check the coherence of their research. Checking that these features link one to another, as shown in Figure 8-1, is a prerequisite for research to be considered as coherent.



**Figure 8-1 Consistency in levels of research (after Rose, 1982)**

### **Consistency and Rigour**

Throughout the research attention has been given to explaining the choices that were faced and the decisions that were made. This sought to provide a clear account of the way that the research was seen, the reasons for my research questions, and the way that the research was designed. Then my choice of research instruments was set in how the fieldwork was conducted as I collected electronic-held data. Due to the form, location and holding of these data its access was without difficulty and no ethical issues arose. In these respects, the vision that drove the investigation was carried through as planned.

The conduct of the research corresponds with the views of Winter, Griffiths and Green, (2000:33÷34). They showed that research results should follow explicitly from the findings, the different angles of the research should be organized to illustrate their significance and the argument in the text should be clearly presented. When these features are present, they suggest, the research can be considered to be coherent.

The planning, structure and execution of my research has been carefully detailed in the preceding chapters. My arguments have been made explicit to present the various perspectives on the topic and show the contrasting views that others have advanced. The text that has dealt with these issues has sought to avoid excessive use of technical jargon so that the flow of ideas enabled others to follow the development of my ideas. Thus, considerable effort has been directed at seeking coherence in the thesis.

Winter et al also suggests that a positive feature of research is intellectual grasp (2000:33). Throughout this investigation the scope and possibilities of the research have been stated. The wider significance of the main issues, CSR and CFP, have been set and explained in their respective managerial and financial settings. This has identified the options that are faced by companies as they seek to balance conflicting demands on their resources yet maintaining a competitive position in their respective market place(s).

The limitations of certain extant research have been acknowledged. In particular, the absence of a substantial literature on how these topics apply in an Israeli business context was a potential restriction. However, using literature that related to other entrepreneurial settings provided a generic perspective on CSR and CFP. This informed my approach to the research design and the analysis of my findings.

Hughes (1976:33-60) argues that theory testing involves evaluating the degree to which it has been possible to move between the 'language of data and the language of theory' (Hughes, 1976:55). He believed that this process was central to the analysis and interpretation of data. The indicators that were used as research criteria represent the links between the theories that were being tested and the empirical direction of my research. My choice of CSR and CFP as the critical features to investigate clearly emphasizes the connection between two business considerations in theory and practice. Thus, the research has used an appropriate language in how theoretical perspectives were reached and in the design and conduct of the investigation.

### **Internal Consistency**

The findings of the research support both hypotheses with regard to the relationship between corporate social responsibility and financial performance. The first test group

compared two groups of companies with different CSR ranking. One group has been ranked with high CSR while the companies in the second group had low CSR ranking. The test showed that the group of companies with high CSR had better financial performance than those companies in the group of low CSR. This finding supports the first hypothesis that being a social responsible company can lead to improved financial performance.

The findings that companies with high CSR had better financial performance than other companies with low CSR are in line with both theory and findings by studies conducted outside Israel. Several theories presented in the theoretical perspective, including the 'stakeholder management' and the 'resource based view'; suggested that companies that adhere to being socially responsible could benefit from improved financial performance. Satisfied stakeholders and improved reputation were the main reasons causing such positive impact on financial performance.

My findings support studies conducted outside Israel that reported a positive relationship between corporate social responsibility and financial performance. Griffin and Mahon (1997) and Orlitzky (2003) who reviewed nearly 100 studies on this issue, reported that the majority demonstrated a positive relationship between CSR and financial performance. My findings correspond with these findings and so it extends the applicability of other theory and research to the local setting of companies in Israel. In this way it accords with Rose's view on theory testing (Rose, 1982: 18) and accords with component A.

The second test compared companies having low, medium, and high levels of social responsibility with regard to their financial performance. The findings showed that the group of companies ranked at medium CSR level had 'better' financial performance than companies with very high and low CSR. The value judgment implied in the word 'better' conveys the higher, more improved and comparatively more financially attractive position than found in other businesses. This implies that increases in levels of corporate social responsibility, reaching a very high level of CSR, will not necessarily result in further increase of financial performance. The evidence showed that beyond a certain level of social responsibility, further increases in social responsibility decreased financial performance. This type of functionality has been

described also as an inverted U-shape curve of relationship between social performance and financial performance (Bowman and Hire, 1975; Moore, 2001; Marom, 2006).

This finding is in agreement with the models of a non-linear relationship between CSR and financial performance. It was Bowman and Hire (1975) who argued that:

*"... more is not monotonically better than less; rather, there is a U-shaped relationship in which some is better (in terms of association with profits) than little or none and that still more tends to be associated with less return than the middle ground" (1975:54).*

Thus, my finding accords with research conducted outside Israel (Bowman and Hire, 1975; Sturdivant and Ginter, 1977; McWilliams and Siegel, 2001).

The phenomenon of increased marginal costs and decreased marginal benefits can be observed throughout the spectrum of the issues involved. Some specific social responsibility expenditure can involve high costs. According to Balabanis et al. (1998) this is the case with environmentally-related activities that might require higher costs and thus are found to be negatively related to subsequent financial performance. For example the effort to decrease air pollution by 80 percent would normally require more than the double resources in comparison to decrease air pollution by 40 percent. This is due to the increasing marginal efforts required in such physical processes.

Other authors (Aupperle et al., 1985; McGuire et al., 1988; Preston and O'Bannon, 1997) pointed out that social expenditure associated with high level of social responsibility may have negative impact on financial performance due to the fact that it is an additional cost without significant returns, or without clearly associated returns. This is true in particular to higher level of expenditure associated with costly dimensions of social responsibility (Balabanis et al., 1998; Barnea and Rubin, 2005). Similarly, Porter and Kramer (2006) suggested that the type and level of social responsibility expenditure should be in alignment with the business sector and its associated stakeholders, otherwise significant expenditure may occur without yielding the associated returns from stakeholders.

The single most important outcome of my research is the evidence that companies in Israel are facing the same phenomenon and results related to social responsibility, as their counterparts in leading western economies. This conclusion resulted from the research design because it used data from Israeli companies. This suggests that managers of Israeli companies can and should use social responsibility as part of their strategic posture aiming to gain increased financial performance.

However, my evidence also confirmed within the Israel context, that more social responsibility is not always better for the 'bottom line'. Findings indicated that there is a peak level of social responsibility beyond which financial performance will decrease. This suggests that there is a need for managers in Israel to monitor the level of social responsibility so that it avoids peaking and entering the zone of negative impact on financial performance. One way of doing it is following the advice of Porter and Kramer (2006) to align the dimension and level of social responsibility with the specific industry sector and business strategy of the firm. Additionally, as suggested by Barnea and Rubin (2005), managers should choose to begin with low cost CSR expenditure ensuring that the firm stays in the zone of positive contribution to the firm value. Over-investment in costly CSR activities may shift the company from a preferred optimal balance point of maximizing financial performance.

From these various perspectives, my research has demonstrated cohesion in two respects. Firstly, it had produced findings that support models and theories from extant literature. This interpretation suggests that it builds on existing theory outside the Israeli context whilst developing theory about the Israeli context. Secondly, the testing of the hypotheses showed that the choice of variables and the manner in which they were tested were empirically internally consistent. The data that were collected during the fieldwork provided appropriate insights to support the hoped-for interpretations. The data were sufficient to test the hypotheses and to substantiate their respective underlying assumptions (Walliman, 2005). This enabled me to show how theory was connected to practice through the research and also in the way that it was conceived.

The methodology that was used followed the traditions of deductive enquiry. Each stage of it was explained and followed on logically to the next. The appropriateness



of this approach is apparent in that it was unnecessary to revise or adjust my research approach during the conduct of the investigation. This might have been necessary if it had become obvious that the research design was unable to deliver what it was intended to do. As a result, it appears that the research process was internally coherent and provided a clear line of reasoning from the research questions to the findings, and onto the conclusions in the following chapter.

Thus, my claim for positive relationships between this research and the external theoretical perspectives implies strategic consistency for the investigation. As Trafford and Leshem (2008:104) argue, 'Research design is a strategic process.' Using Rose's model I have shown how my research has demonstrated a strategic view of intentions and displays internal consistency.

### **Chapter Summary**

This chapter has provided an interpretation of the research. It has shown how the components of the investigation link together to create a coherent piece of work. It has also indicated how the conclusions that follow are based upon a strategic vision for the design and execution of the study. The outcomes from testing the hypotheses were considered and this provides evidence for the conclusions in Chapter 9.

## **Chapter 9 Conclusions**

### **Introduction**

The structure of this chapter follows two principles suggested by Trafford and Leshem (2008:170) by cross-linking between the beginning and the end of the research, and offering conclusions from the specific or descriptive through to the general and conceptual. First, the chapter provides a brief review of the research intentions and links these to the discussions of the findings. Second, the chapter provides conclusions that progress from the factual level and onto conceptual conclusions and the generalisability of the findings.

### **Purposes of the Research**

This research investigated the relationship between corporate social responsibility (CSR) and corporate financial performance (CFP) for corporations in Israel. The investigation was undertaken between 2005 and 2006 and it involved leading companies which form the Tel-Aviv 100 (TA 100) index in the Tel-Aviv Stock Exchange (TASE).

The research aimed to bridge the gap between the evolving practices of investment in social responsibility among companies in Israel. This was based on diffusion of ideas coming from the international community, and the lack of local research that informed this topic.

Some companies in Israel have already adopted practices of social responsibility as reflected by their own statements, as well as shown by the independent ranking and reports by MAALA. This course of action by many of those companies' executives could be interpreted as mimicking ideas and practices from the international community. Those executives might be regarded as 'Early Adopters' according to Rogers' (2003) views on the diffusion of innovations. Accordingly, early adopters executives are quick to adopt new ideas to advance their business, without the need for conclusive proof. For such managers, early information from abroad about the potential benefit of social responsibility, without research that could show similar

results in Israel, could be enough to adopt such practice. However, the majority of executives, as suggested by Rogers, seek locally-based evidence regarding the benefits to their company's bottom line of corporate social responsibility. Such locally-based evidence was non-existent when this research was undertaken.

My research was undertaken for both theoretical and practical reasons. On the theoretical level it sought to fill a gap in knowledge about the relationship between corporate social responsibility and financial performance for corporations operating in the Israel environment. In this sense, it identified emerging issues that were worthy of investigation and then investigated them. Such research can have practical implications, and thus provide research-based evidence that could inform executive behaviour. According to Porter and Kramer (2006), adopting the practice of corporate social responsibility can greatly contribute to the competitive advantage of businesses in the contemporary global competitive environment. This was my second reason for undertaking the research

The research questions for this research were answered in this way:

The research found a positive relationship between CSR and CFP, for companies in Israel, supporting investment in CSR to a certain level beyond which this relationship turns negative.

### *The hypotheses*

Thus two hypotheses were formulated:

#### Hypothesis 1:

H<sub>0</sub>: The CFP does not increase as the level of CSP increases

H<sub>1</sub>: The CFP increases as the level of CSP increases

#### Hypothesis 2:

H<sub>0</sub>: There is no peak point beyond which CFP decreases as the level of CSP increases

H<sub>1</sub>: There is a peak point beyond which CFP decreases as the level of CSP increases

The findings support the view that Israeli companies should consider becoming more involved in social responsibility as a way to improve their financial performance.

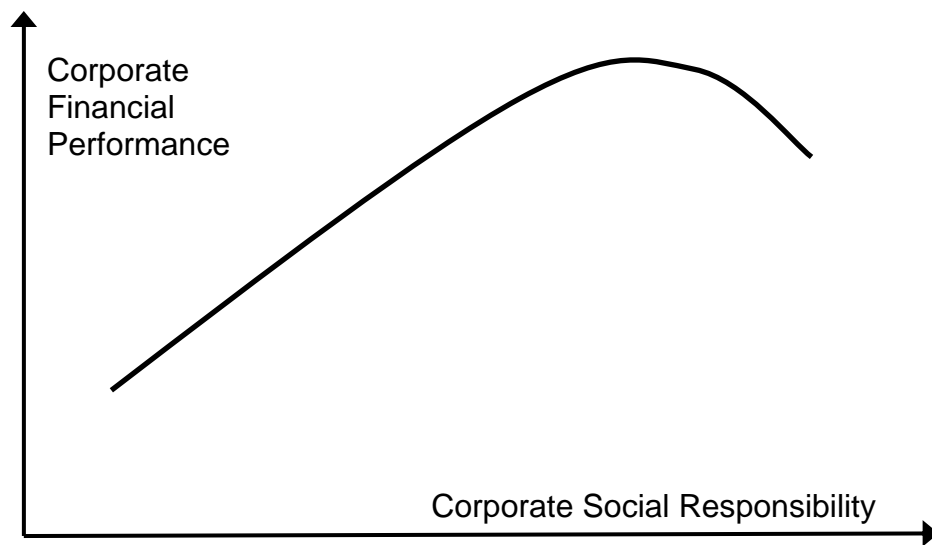
Although the costs incurred by actions of social responsibility are tangible and potentially immediate, managers could interpret them as an investment that will bring benefits at a later stage rather than as an expenditure. This is very similar to investment strategies in research and development (R&D). Most managers understand that cost of R&D should not be regarded as expenditure, but rather as an investment that will bring returns in the future. Thus, business justifications for the start-up costs of social responsibility are similar to strategic investments in R&D.

Actions of social responsibility will evoke benefits through mechanisms which are specific to internal and external stakeholder groups. Employees, which are stakeholders internal to the company, have been shown to provide significant returns to social responsibility investments (McGuire et al., 1988; Waddock and Graves 1997). Corporate social responsibility strategies can improve the productivity and creativity of workers resulting in improved financial performance.

My evidence shows that the relationship function between social responsibility and financial performance for companies in Israel reflect similar relationships to companies in leading western countries. This proved similarity suggests that the practice and use of CSR could be adopted more widely in Israel. Thus, the factual evidence now removes the practical ‘proof’ which many Israeli managers sought before committing themselves to adoption of CSR as a way to achieve competitive advantage.

### **Factual Conclusions**

This research has provided evidence that social responsibility can lead to enhanced financial performance. It also found that the relationship between social responsibility and financial performance for companies in Israel is a non-linear relationship that resembles an inverted U-shape curve. This means that when companies start with social responsibility actions they are likely to benefit from increased financial performance. Further increase in the level of social responsibility will result in further enhancement in financial performance. However, at a certain high peak level of social responsibility there is a stall in further increase in financial performance. Beyond this peak further increases in responsibility outputs will result decrease financial performance, as shown in Figure 9-1 (132).



**Figure 9-1 A non-linear relationship between CSP and CFP**

This kind of relationship, found for companies in Israel, is in-line with models described in the literature review (Bowman and Hire, 1975; Sturdivant and Ginter, 1977; McWilliams and Siegel, 2001; Marom, 2006).

### **Conceptual Conclusions**

The components of my conceptual framework ~ the company, financial performance, social responsibility and stakeholders ~ provide key considerations for these conceptual conclusions. Evidence has been presented that shows these components to be interconnected through patterns of expenditure and the marketplace appreciation of social responsibility.

My research finding provide support to the stakeholder theory of the firm (Freeman, 1984), and the stakeholder management concept (Donaldson and Preston, 1995; Mitchell et al., 1997; Preble, 2005) thereof, which suggested a positive relationship between corporate social responsibility and financial performance. That is that if managers are taking care to identify the expectations of their stakeholders, and address them properly, they are likely to benefit from improved financial performance.

Similarly, my research results support the social impact hypothesis (Cornell and Shapiro, 1987; Preston and O'Bannon, 1997) and the resource base view of the firm

(Barney, 1991). Those two concepts also suggested a positive relationship between corporate social responsibility and financial performance, each from a different point of view. Thus, evidence from my research support the view that corporations that act to satisfy their various stakeholder groups, can expect that their financial performance will improve through actions of their stakeholders. Additionally, my research provides support to the assumption by the resource based view that social responsibility builds reputation, which contributes to comparative advantage that leads to improve financial performance.

My research finding not only provides support to those theories about the positive impact of social responsibility on financial performance, but it shows that these concepts are holding true for companies in Israel. This provides managers of companies in Israel the sought after local based evidence that social responsibility does lead to improved financial performance. These findings provide grounds, as suggested by Porter and Kramer (2006), to include social responsibility as an important part in strategic management of companies in Israel.

My research findings also provide support to the notion that 'more is not necessarily better' (Bowman and Hire, 1975). It complies with findings by Bowman and Hire (1975) and Sturdivant and Ginter (1977) to show that beyond a certain level, higher level of social responsibility can have a negative impact on financial performance. This, in turn, provides support for an inverted U-shape relationship, between social responsibility and financial performance, suggested by my previous work on the 'Unified Theory' (Marom, 2006). That is that financial performance are rising with increase of social responsibility, reaching a pick beyond which further increase in social responsibility will cause decline in financial performance.

The findings of my research demonstrate that companies in Israel face the same relationship between social responsibility and financial performance as reported through research worldwide. In this sense, it provides research-based evidence that could serve informed behaviour of managers in Israel, with regard to social responsibility, similar to recommendations provided through the general research of the subject area. Practically, companies in Israel are advised through this research to

incorporate social responsibility as a means to create competitive advantage which could then lead to improved financial performance.

The deductive nature of this research ensures that the findings are reliable. They can be replicated by using similar methodologies to those in this investigation. This means that the conclusions are generalisable and can be adopted by corporate managers who wish to develop or pursue policies of social responsibility.

### **A Critique**

Six aspects of this investigation are subjected to a critique. Each represents a critical component or perspective where my choice of approach or methodology warrants reflection on actions taken (Schön, 1991: 129). Whilst in each of these cases the progress of the research was not hindered none-the-less it is worth providing further thoughts on them in retrospect.

#### *Secondary sources*

The data for this investigation was drawn from secondary sources. The rationale for this was provided in Chapter 6. The understandable preference by researchers to use primary data is advanced on the premise that such data is up-to-date, and therefore it provides an accurate portrayal of the issues under investigation. Whilst this view is understandable, it depends on the availability of, and access to, the required data. Implicit in this view is that the cost of accessing the data can ‘somehow’ be covered by researchers themselves. However, the cost of accessing primary data, and the associated imposed restrictions by those who authorize access, may introduce major limitations on the feasibility of such an investigation. My decision to use secondary data avoided these potential difficulties and so enabled me to complete my research within an acceptable timescale and at minimal cost. However, this research could be replicated each year by a researcher who also accessed secondary data. In that way a cumulative picture could be assembled on these issues ~ one year behind a primary-data-based investigation. Thus the advantage of being able to access secondary data free of direct costs and at a convenient time to me outbalanced the alternative of paying and waiting for primary data.

### *CSR measurement*

Social responsibility cannot be gauged directly, but rather through indicators, and thus cannot be regarded as an absolute number. Despite this potential limitation, this measuring system is regarded to be the best practice (Griffin and Mahon, 1997; Rowley and Berman, 2000; Porter and Kramer, 2006). However, the question of adequacy of the aggregated number which is calculated to have a single yardstick for comparison of social responsibility ranking of companies belonging to different business sectors was acknowledged. Some authors questioned whether it is correct to compare two companies having the same aggregated social index, which is calculated from different CSR dimensions due their affiliation to different business sector. These factors were accommodated in my research design and the interpretation of findings and thus acknowledged the issue. The analysis of my data did not raise difficulties in this respect.

### *Sample*

My research referred to companies that compose the Tel-Aviv-100 index, in TASE. It has been argued (Preston and O'Bannon, 1997; Margolis and Walsh, 2001) that large companies have sufficient slack resources that are invested in campaigns to promote their positive image via social responsibility and green policies. Such perceived public image does not necessarily reflect the actual level of social and environmental responsibility. For such companies it is the high level of financial performance that is the cause for high social responsibility with an accompanying real or perceived image. The evidence that was assembled was drawn from 60% of the potential companies for the sample. This represents the majority of those companies that could have been within the Universe for this investigation. It is therefore statistically significant and could not have been increased within the parameters of the research design.

### *Causation*

This research did not revoke the possibility that there might be a confounding variable which may be associated with both the independent and dependent variable. Thus, there is a possibility that such a confounding factor is causing the seemingly relationship between CSP and CFP. If such a confounding factor exists it is a threat to



the validity of the inferences made about the relationship between the dependent and independent variables.

### *Effect of globalisation*

The sample companies were selected from the TA-100 index, which means that they are big corporations, with many operating globally. TEVA for example, a well-known pharmaceutical company, operates in over 20 countries, with customer bases in over 80 countries. Israel counts for less than 20% of its employees and 10% of its customer base. This means that the effective environment in which such a company operates does not represent the business environment of Israel, but rather it has a pluralist mixture of environments and cross-cultural effects.

Multinational companies have to consider issues arising from their operations in different countries with different cultures (Crane and Matten, 2004: 20). Guidelines and practices used in their home countries adapt to international environments such as local labour laws and practices, accountability issues, culture attributes, ethical practices and codes, and environmental issues. Thus, it is expected that multinational companies would change their social responsibility practices to adapt to their global operation. Therefore, because the sample included multinational companies, it might be that they do not fully represent the situation regarding companies which operate only under the Israeli business environment.

### *Other research*

My research design, which assumed the possibility of non-linear relationship, has rectified a methodological concern with past research. Many previous researchers investigated the relationship between corporate social responsibility and financial performance through assuming a linear relationship. Under this assumption, those studies adopted research designs that, consequently, prevented them from discovering non-linear relationships between CSR and financial performance. Thus, their findings were inevitably either positive relationship, negative relationship, or no relationship that could be established. Since the studies were deductive in nature, the most common finding was of positive relationship which is characteristics to first part of the relationship, while the level of social responsibility is not extremely high.

My research was based on the assumption that the relationship follows the 'Unified Theory' which predicts an inverted U-shape function. Thus, my research design had to be such that permitted non-linear findings. Accordingly, my research design followed practices that were used by Bowman and Hire (1975) and Sturdivant and Ginter, (1977). For that purpose, there had to be a distinction between medium levels of social responsibility and lower and higher levels. This design allowed for the finding that medium levels of social responsibility might provide higher financial performance than for lower and higher levels of social responsibility. Thus, the form of research design that was adopted in my research was appropriate to its purpose.

### **Further Research**

My research provides evidence that could encourage corporate managers in Israel to implement social responsibility in order to enhance financial performance. Further research in Israel could illuminate this issue.

First, related to this investigation, research could address the financial implications of company size and local operation. Such investigations could overcome the potential limitations of this research that focused on companies composing the TA-100 index of the TASE by focusing on medium size companies, as well as companies that operate in Israel only. Both foci of research would add to understanding regarding the relationships between the variables of slack financial resources, company size and involvement in social responsibility initiatives.

Second, more research could investigate causation mechanisms through which social responsibility affects financial performance in Israel. The knowledge about such mechanisms could formulate models that illustrate optimal strategic uses of social responsibility that advance competitive advantage. Thus, research on causation could generate specific social responsibility strategic models that optimize CSR policies for business.

My long-time professional interest in how companies view and engage with social responsibility has been strengthened by my doctoral study. I intend to seek

opportunities to disseminate my findings and to extend this research as indicated above.

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