

The Impact of Social Variables on Financial Performance

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ABSTRACT: In recent years, the discussion on corporate social responsibility has surged and firm management are seen to devote more efforts and resources towards improving their social image. Even under such intense public scrutiny, product recalls in the electronics, automotive, and healthcare sectors have not declined. Quality issues persist due to the severe competitive pressure to meet time to market' product launches. Carbon emissions and green-house gases generated by industrial manufacturing, waste disposal, and automotive vehicles also continue to rise. The research purpose was to investigate the impact of individual social variables on financial performance. This research paper used multiple linear regression to assess the relationship between key indicators of corporate social responsibility and financial performance from 372 corporations in the S&P500 in 2014. The theoretical foundation was Freeman's stakeholder theory. Environment, community, human rights, diversity, employee relations, product quality, and corporate governance were measures of social performance. Return on assets was used to measure financial performance. When independent social variables were evaluated with corporate financial performance, employee relations and product quality in the healthcare sector, and community in the financial sector, were found to be positively significant. Environment, product quality, and corporate governance in the financial sector, and employee relations in the consumer and energy sectors, were found to be negatively significant. This research revealed that the relationship between some social variables and financial performance are significant, but not always in a positive direction. Based upon the findings established in this paper, managers can use the findings to evaluate their firm's social position, develop strategies to address gaps, and undertake actions to enhance their firm's social performance, thereby creating positive social change in the community.

KEYWORDS: social variables, corporate social responsibility, financial performance, stakeholder theory

Introduction

In the past decades, the discussion on social and environmental issues have become more prevalent in the corporate boardroom. What are the key metrics that will determine a company's social performance? What is the impact on the investment of resources towards social responsibility with financial performance? If it is so determined that socially responsible companies are more profitable, what are the key social metrics that managers should focus on? Friedman (1970) asserted that the primary purpose of corporations is to maximize returns to shareholder while Freeman (1984) proposed the stakeholder theory, that in addition to a firm's corporate fiscal responsibility, there are other key stakeholders that should be accorded attention. Whose philosophy should organizational leaders follow? This paper provides a discussion on corporate social responsibility, an analysis of the key social variables, and investigate their impact to financial performance.

Literature Review

In the initial phases of a firm's start-up, the founder's mission and purpose is to serve their customers and the needs of the society through the sales and distribution their products and/or services. As the firm grows and expands its market reach, the returns on sales and profits follow the same pattern. Profits are reaped as a result of the competitive advantages and unique value propositions secured by the firm in the market. In these phases of growth and expansion, though the idea of corporate social responsibility (CSR) has not been explicitly promoted, such a philosophy should be no doubt an inherent trait (Lim 2017). As firms' market capitalization grows and eventually achieve a public corporation status, the pressure exerted on executives to maximize firm profits is exacerbated (Friedman 1970). Such a path is one that all large corporations must travel and that unfortunately leads the firm on a road to chasing

bigger returns quarter after quarter. To that end, the global environment experienced a surge of climate and environmental issues in the recent decades attributed to increasing pollution caused by heavy manufacturing industries. Environmental crises due to corporate irresponsibility has also increased significantly in the last few decades. Examples might include the Bhopal chemical disaster in 1984, the Chernobyl nuclear accident, and the BP oilrig at Deep Water Horizon's explosion resulting in an oil spill in the Gulf of Mexico (Crossman 2011).

The philosophy and thinking of CSR has existed for more than six decades. It began in the 1950s when Bowen (1953) first developed the viewpoint that businessmen must consider their obligations to the society at large while making decisions or formulating policies surrounding their business' objectives. Various stages of development and evolution of the CSR framework ensued. Lee (2008) described the evolution of the CSR milestones as follows: "social responsibilities in the 1950s-1960s, enlightened self-interest in the 1970s, corporate social performance model in the 1980s and strategic management in the 1990s." Most firms do not question the necessity to adopt good CSR behaviour however, the question that arises is what is the impact of CSR with financial performance (Harrison & Wicks 2013)? The question on whether CSR is a necessary undertaking has also puzzled academics and practitioners for a long time until recently. The United Nations Global Compact reported that more than 8,000 companies from more than 150 countries are signatories to the United Nations' Global Compact, covering issues on human rights, labor standards, the environment, and anti-corruption initiatives (UN Global Compact 2014). This illustrates a shift from treating CSR as a secondary variable of corporate strategy to an elevated status in the organizational strategic planning process. The Indian conglomerate, Tata Sons, appoints a senior executive to lead the group's CSR strategy with the title as chairman of the Tata global sustainability council (Wang, Tong, Takeuchi, and George 2016). In addition, over 4 Trillion dollars have been reported to be invested in socially responsible investment funds (Social Investment Forum 2014) and an estimated three-quarters of all S&P500 firms in the United States publish an annual CSR report (Governance and Accountability Institute 2015). Government of nations have even stepped in to mandate CSR contributions. In India, corporations must invest 2% of their net profits in CSR (Wang, Tong, Takeuchi, and George 2016).

Societal value is created and trade is equitable when corporate executives manage and treat all their stakeholders fairly (Freeman 1984). In addition to the shareholders, stakeholder theory asserts that there are other players who are also important to a firm. These players are termed stakeholders and should also be accorded the appropriate care and attention. These stakeholders are the employees, customers, suppliers, the financiers, and the people within the community whom the firm does business with. When all the stakeholders are treated fairly and become convinced of the firm's purpose of business, they will be motivated to support the firm's objectives and move in the same direction, thereby creating value for the firm and the society.

Bridoux and Stoelhorst (2014) reported on a case study exploring the management approaches undertaken by two airline firms, Southwest and RyanAir. Southwest doted on their employees, customers, and other stakeholders with great care and integrity while their competitor, RyanAir hired employees with poor packages, customer satisfaction reports were low, and other stakeholders were not accorded the due care and attention. It was found that Southwest continuously delivered strong financial results, built a strong brand, and carved a niche as a reputable budget carrier in the airline industry. While RyanAir's financial results improved in the short-term, RyanAir suffered significant impact and detriment to the brand, reputation, and financial performance in the long term (Bridoux & Stoelhorst 2014).

A firm's product acceptance could be influenced by customer values. Surroca, Tribo, and Zahra (2013) found that in the automobile industry, customers who are concerned with the protection of the environment may be more inclined to purchase from firms whose management philosophy explicitly professes their environmental strategy, goals, and objectives. To illustrate this point, Tesla, a recent entry to the auto industry, credited as an innovator and pioneer of electric cars has appealed to a wide range of auto consumers, not just the early adopters but also conventional

auto customers (Oremus 2013). Tesla's automobiles are not only free of carbon emission, they are also contemporary in style with state-of-the-art features.

Having acknowledged the necessity that firms should adopt positive CSR, how can a firm measure their CSR efforts and stakeholder contribution? Perrini, Russo, Tencati, and Vurro (2011) stated that CSR efforts are generally categorized into six main areas: (a) internal organization, (b) customers, (c) supply chain, (d) society, (e) natural environment, and (f) corporate governance. These efforts can be evaluated as the measure of corporate social performance (CSP). Corporate social performance (CSP) is defined as a measure that evaluates the performance of an organization in attending to the interests of the stakeholders (Gama Boaventura, Santos da Silva, & Bandeira-de-M 2012). Barnett (2007) described CSR as a snapshot of a firm's overall social performance at a particular point in time, a summary of the firm's aggregate social posture. According to Chang, Kim, and Li (2014), the increase on the public reporting of CSP in Fortune 500 firms from 2000 to 2012 has increased to 53% from close to zero. The emphasis on CSP as a contributor to overall corporate performance is hereby illustrated.

Having ascertained the independent variables that make up CSR, what are the measures that can be used to evaluate a firm's financial performance? The measure of a firm's economic or profitability position at any given time is defined as corporate financial performance (CFP). The measures for CFP for firms are not based on a single metric but a variety of financial metrics. There are two main categories: (a) accounting based, and (b) market based. Relative to the accounting based metrics, most researchers utilize the following metrics: (a) ROA (Berman, Wicks, Kotha, & Jones, 1999; Choi & Wang, 2009), (b) Return on Equity (ROE), or (c) Return on Sales (ROS) (Callan & Thomas 2009). Accounting based measures are based on evaluation of a firm's unique characteristics, and provide firm management and investors a good source of data about the firm's past performance (Bahhouth, Maysami, and Gonzalez 2014). ROA was the most commonly used metric to measure financial performance (Berman, Wicks, Kotha, & Jones 1999; Gama Boaventura, Santos da Silva, & Bandeira-de-M 2012; Tang, Hull, and Rothenburg 2012). In previous CSP-CFP studies, it was also found that ROA is the most commonly used metric to measure financial performance. In light of the validation by previous researchers that ROA is a reliable metric to evaluate firm financial performance, ROA as the measure of the dependent variable (CFP) was used in this research.

Research Method

The purpose of the research is to ascertain if there is a significant relationship between individual CSP variables with financial performance. First, the key social performance metrics will need to be established. Individual CSP variables was constructed through an analysis of seven independent categories: (a) corporate governance, (b) community, (c) diversity, (d) employee relations, (e) environment, (f) human rights, and (g) product quality. These independent variables established were ESG ratings obtained from the STATS data set at MSCI research, formerly known as the KLD database. Seven variables constituted CSP: CGOV, DIV, HUM, ENV, COM, PRO, and EMP. Within each CSP variable, there were multiple performance indicators. In total, there were 71 indicators scored. A combination of positive (or strengths) and negative (or concerns) performance indicators was built into each CSP variable. The ENV variable consisted of 16 positive indicators and seven negative indicators. An example of a positive indicator for ENV was Environmental Opportunities – Opportunities in Clean Tech, and a negative indicator was Toxic Emissions and Waste. The overall composition of the CSP variables and indicators was tabulated as follows: CGOV (two positive, four negative), DIV (two positive, two negative), HUM (two positive, three negative), ENV (16 positive, seven negative), COM (one positive, one negative), PRO (10 positive, six negative), and EMP (nine positive, six negative).

Firm CFP was the dependent variable, measured using ROA. The dependent variable, CFP, was measured using annual ROA data reported in the 1-year period. To gather ROA data, annual 2014 ROA from was mined from CSI Market, a research firm that specializes in the field of financial reporting. Data from 372 firms in the S&P500 database for calendar year 2014 was

subsequently collected. Because the data were collected from 372 firms in the S&P500 index, the results were suitable for generalization with the population of U.S. firms that employ more than 1,000 employees. S&P500 firms constitute approximately 80% of the market capitalization of U.S. firms (Silverblatt 2015), so the bandwidth of overall industry coverage was significant. A multiple regression analysis was conducted on the individual CSP independent variables and one dependent variable that defined CFP. Based on MSCI's methodology (MSCI 2016), individual performance indicators in the CSP variables were scored using a binary scale. If a company met the assessment criteria established for an indicator, then this was signified with a 1. If a company did not meet the assessment criteria established for an indicator, then this was signified with a 0. If a company had not been researched for a particular ESG indicator, then it was signified with NR (not researched). The following research question and hypothesis was adopted:

What is the relationship between specific CSP variables and CFP in calendar year 2014 in the S&P500 firms?

H₀: No relationship exists between any of the CSP variables and CFP.

$$\beta_1 = \beta_2 = \beta_3 = \beta_4 = \beta_5 = \beta_6 = \beta_7 = 0$$

H_a: A significant relationship exists between at least one of the CSP variables and CFP.

Not all the β_i ($i = 1, 2, 3, 4, 5, 6,$ and 7) are zero.

To test the hypothesis, data was analyzed using the following regression model:

$$CFP = \beta_0 + \beta_1 ENV + \beta_2 EMP + \beta_3 CGOV + \beta_4 PRO + \beta_5 COM + \beta_6 DIV + \beta_7 HUM$$

A level of significance $\alpha = 5\%$ was established to evaluate if the null hypothesis is to be rejected.

Results

A total of 454 firms were registered in the S&P500 on December 2014, not the entire 500 because 46 firms were eliminated due to liquidation, mergers, and acquisitions during calendar year 2014. The firms were classified into nine industry sectors based on the S&P500 industry classification: (a) consumer (CON), (b) energy (ERG), (c) financial (FIN), (d) health care (HC), (e) industrial (IND), (f) information technology (IT), (g) materials (MAT), (h) telecommunication (TELCO), and (i) utilities (UTI). Out of the 454 firm units entered into the database to extract the ROA data, 24 firm units were missing from the CSIMarket database. The data set was thus reduced to 430 units at this step of the data collection process. Firms that did not have CSP data records were then eliminated from the data set. In the process of cleaning and clearing the data set, the data set was further reduced to 372 firm units.

Table 1: Classification of Final Data Set by Industry Sector (n = 372)

Industry	CON	ERG	FIN	HC	IND	IT	MAT	TELCO	UTI
Firm units	84	31	65	39	49	52	22	4	26

Table 2: Descriptive Statistics of Final Data Set (n = 372)

	Industry	ROA	Aggregate CSP
N Valid	372	372	372
N Missing	0	0	0
Mean	3.96	7.06	3.40
Median	4.00	6.00	3.00
Mode	1.00	0.85	2.00
Std. Dev.	2.39	5.07	2.14
Min	1.00	0.07	0.00
Max	9.00	34.79	11.00

Table 3: Descriptive Statistics of CSP Variables (n = 372)

	ENV	COM	HUM	EMP	DIV	PRO	CGOV
N Valid	372	372	372	372	372	372	372
N Missing	0	0	0	0	0	0	0
Mean	1.01	0.12	0.18	0.82	0.00	0.38	0.89
Median	1.00	0.00	0.00	1.00	0.00	0.00	1.00
Mode	0.00	0.00	0.00	0.00	0.00	0.00	1.00
Std. Dev.	1.18	0.33	0.50	0.99	0.00	0.61	0.78
Min	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Max	5.00	1.00	2.00	5.00	0.00	3.00	3.00

To address the research question, a multiple linear regression analysis was conducted to evaluate the prediction of ROA (a measure of CFP) from a model with all CSP variables: ENV, COM, HUM, EMP, PRO, and CGOV across the data set of 372 units. The variable, DIV was removed as there was no available scoring provided at that point of time. The results of the multiple linear regression analysis found that the p value for the entire model, all independent CSP variables, was $> .05$. Thus, the null hypothesis for this model was not rejected. To further investigate if individual CSP independent variables were significant with CFP as the dependent variable (measured by ROA), a simple linear regression analysis was conducted for each individual CSP variable with CFP. The p values for all CSP variables were found to be $> .05$. Subsequently, an additional multiple regression analysis was undertaken to evaluate the prediction of CFP from a model with all independent variables (ENV, COM, HUM, EMP, PRO, and CGOV), with the data set segregated by industry sectors. Significant relationships were found in several sectors.

For the consumer sector, the individual variables revealed a significant relationship between EMP and CFP (p value was found to be 0.031, which is $< .05$). For the energy sector, the individual variables revealed a significant relationship between EMP and CFP. The p value was found to be 0.012, which is $< .05$, thus explaining a significant relationship. For the financial sector, the multiple regression analysis revealed that the overall regression model was significant ($p = 0$). Examining the individual variables revealed a significant relationship between four CSP variables (ENV, PRO, CGOV, COM) and CFP. The p values for ENV, PRO, CGOV, and COM were found to be .035, .022, .000, and .012 respectively.

Table 4: ANOVA Table-Specific CSP Variables By Industry Financial Sector (n = 65), y = CFP

Source	SS	df	MS	F	p value	R^2	Adjusted R^2
Regression	582.319	6	97.053	5.028	.000	.342	.274

Table 5: Coefficients Table- Specific CSP Variables By Industry Financial Sector (n = 65), y = CFP

Source	B	Beta	Sig.	Lower C.I.	Upper C.I.
(Constant)	8.022		.000	5.396	10.647
ENV	-1.417	-.241	.035	-2.731	-.102
COM	7.060	.332	.012	1.631	12.489
HUM	-4.059	-.195	.135	-9.425	1.307
EMP	.166	.032	.770	-.962	1.294
PRO	-2.552	-.290	.022	-4.719	-.384
CGOV	-3.076	-.460	.000	-4.715	-1.437

For the healthcare sector, the multiple regression analysis revealed that the overall regression model was significant ($p = .005$). Examining the individual variables revealed a significant relationship between CFP and two CSP variables: EMP and PRO. The p values for EMP and PRO were found to be .011 and .012 respectively.

Table 6: ANOVA Table-Specific CSP Variables by Industry Healthcare Sector (n = 39), y = CFP

Source	SS	df	MS	F	p value	R^2	Adjusted R^2
Regression	461.188	4	115.297	4.439	.005	.343	.266

Table 7: Coefficients Table- Specific CSP Variables By Industry Healthcare Sector (n = 39), y = CFP

Source	B	Beta	Sig.	Lower C.I.	Upper C.I.
(Constant)	5.758		.001	2.613	8.904
ENV	.783	.158	.327	-.815	2.380
EMP	2.663	.381	.011	.642	4.684
PRO	4.525	.379	.012	1.083	7.967
CGOV	-1.435	-.217	.166	-3.496	.627

In summary, significant relationship, albeit a negative relationship, was found between EMP and CFP, in the consumer and energy sectors. In the financial sector, a significant relationship was found between four CSP variables (ENV, PRO, CGOV, and COM) and CFP. Three CSP variables, ENV, PRO, and CGOV, were found to have a negative relationship with CFP. COM was found to have a positive relationship with CFP. In the healthcare sector, a significant and positive relationship was found between two CSP variables, EMP and PRO, and CFP.

Table 8: Regression Results on p and Coefficient Values, y = CFP

Variable	Overall (n=372)	Financial (n=65)	Material (n=22)	Consumer (n=84)	Energy (n=31)	Healthcare (n=39)
Agg. CSP	0.717 -0.045	0.015 -0.967	0.034 -1.115	0.100 -0.380	0.880 -0.043	0.127 0.698
ENV	0.443 0.176	0.035 -1.417	0.325 -1.004	0.324 0.381	0.955 -0.138	0.327 0.783
COM	0.359 -0.902	0.012 7.060	0.922 -1.291	0.199 -2.034	0.703 0.498	- -
HUM	0.848 0.126	0.135 -4.059	0.742 -3.325	0.321 1.253	0.617 -0.412	- -
EMP	0.491 -0.187	0.770 0.166	0.639 -0.956	0.031 -1.446	0.012 -4.448	0.011 2.663
PRO	0.290 0.473	0.022 -2.552	0.351 -1.985	0.411 -0.634	0.708 0.884	0.012 4.525
CGOV	0.189 -0.455	0.000 -3.076	0.791 0.863	0.090 -1.597	0.169 0.770	0.166 -1.435

Discussion

Based on the regression analysis results, in both the consumer and energy sectors, a significant relationship, albeit a negative one, between EMP and CFP was found. In the financial sector, the multiple regression analysis revealed a significant relationship between four CSP variables (ENV, PRO, CGOV, and COM) and CFP. In the health care sector, the multiple regression analysis revealed a significant relationship between two CSP variables (EMP and PRO) and CFP.

In the financial and the material sectors, the analysis consisted of 65 and 22 firms respectively. The top 65 global financial firms such as American Express, Bank of America, Goldman Sachs, Wells Fargo, and others consisted of the financial sector. Three CSP variables ENV, PRO, and CGOV, were found to have a negative relationship with CFP. Typically, the impact of environmental concerns such as toxic emissions and waste, packaging materials and disposal, and other environmental factors are minimal in a financial services industry. Therefore, the negative relationship between ENV with financial performance might not be a critical issue. However, the negative relationship between product quality and corporate governance with financial performance was concerning. Weber, Diaz, and Schwegler (2014) found that CSR performance related to corporate governance, business ethics, product responsibility, and labor issues were relatively lower in the financial sector compared with the other sectors. Moreover, deceptive tactics adopted in Wells Fargo's marketing and advertising of their financial products reported by the bank's customers in 2016 was another recent corporate scandal that plagued the financial industry. Corporate governance has been a prevalent issue within the financial industry after the 2007-2008 financial crisis. It could be inferred that firms might still be working toward economic recovery post 2007-2008 and that the investments in CSP might not yet have yielded the desired financial returns. However, the alternative argument could be that investments in CSP might be counterproductive in the relationship with financial performance, and consequently firm management might neglect the essence of product quality and business ethics in the pursuit of shareholder value. The CSP variable, COM, was found to have a positive relationship with CFP in the financial sector. More than 6 years have passed since the 2007-2008 financial crisis, and these results provided further insights, as well as questions, on the impact of each CSP variable on CFP. This is an industry that continues to be haunted by corporate scandals and controversies over the years and therefore would warrant further investigation.

In the consumer and energy sectors, a significant relationship, albeit negative, was found between EMP and CFP. The analysis for the consumer and energy sectors consisted of 84 and 31 firms respectively. The findings implied that positive contribution towards EMP might impact CFP negatively. The consumer sector is the largest subset in the study and consisted of the top global consumer and retail firms such as Starbucks, McDonalds, Nike, and others. To uncover a negative relationship between employee relations with financial performance was alarming because a firm's competitive advantage in the consumer retail industry is critically dependent on the contribution of employees. For example, Howard Schultz, the CEO of Starbucks, is a strong believer in building strong employee relations. Starbucks employees are treated with utmost respect, dignity, and offered generous health benefits. The plausible interpretation in this scenario is that the costs and investments on employee relations outweighed the financial performance measured during this period of analysis. Such an interpretation would mean that firms have taken the steps in developing employee relations, but financial performance has yet to be accounted for. Bridoux and Stoelhorst (2014) suggested that investment in employee relations leads to better corporate performance; therefore, the relationship between EMP and CFP should be investigated at a deeper level.

In the health care sector, a significant relationship between two CSP variables (EMP and PRO) was found with CFP. Both CSP variables were found to possess a positive relationship with CFP. In this sector, the analysis consisted of the top 39 health care firms such as Johnson and Johnson, Baxter International, United Health Group, Pfizer, and others. As health care is a service-oriented industry, the development of talent is a key success factor. Product quality in the area of providing competitive health care products and services would also enhance a firm's competitive advantage. The positive relationship between EMP and PRO with financial performance confirmed the hypothesis proposed in this paper.

The findings in the study were mixed and vary by industry sectors. A direct and causal relationship between CSP and CFP cannot be derived from these findings at this point. However, the implications derived in the discussion could provide managers and practitioners in the field a high-level insight of the CSP-CFP relationship with the potential to undertake further analysis or research. In addition, stakeholders responsible for the management of their respective sectors could

use the knowledge and data found in this study to take positive social change and actions so as to address relevant social performance issues. The findings from this study provide further impetus for continued research and investigation on CSR with financial performance.

Conclusion

In recent years, the discussion on CSR has surged and firm management are seen to devote more efforts and resources towards improving their CSR image. Although significant progress has been made, much effort remains. Even under such intense public scrutiny, product recalls in the electronics, automotive, and healthcare sectors have not declined. Quality issues persist due to the severe competitive pressure to meet time to market' product launches. Carbon emissions and environment pollution generated by industrial manufacturing, waste disposal, and automotive vehicles also continue to rise.

As compared with previous studies that commonly used aggregate measures of CSP, this paper studied CSP at a deeper level using individual variables and confirmed a significant relationship is evident between CSP and CFP in specific industry sectors. Since the data applied is cross-sectional i.e. one-year period, future research analysis can be undertaken with longitudinal data whereby CSP with CFP performance levels can be studied over a longer time period. Based upon the findings established in this paper, managers can identify the significant social variables in their respective industry sectors. their correlation with financial performance, and decide next steps on CSR strategy.

Although the findings in this paper are not conclusive, corporate social responsibility should nevertheless be a priority. Firms must stay committed to produce environmentally friendly and high-quality products. Strong corporate governance policies act as a safeguard. Develop and nurture strong working relations with the employees, support the community through charitable donations or participation in community projects are positive social actions. The safeguard of human rights in business operations and promoting diversity in the workplace are issues that should not be neglected. Across the global landscape, large corporations carry the clout, influence, and authority on social responsibility matters and thus have a very important moral obligation and responsibility to make this significant contribution to society.

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