

RESEARCH NOTE

*The Corporate Social-Financial
Performance Relationship*

A Typology and Analysis

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This research note analyzes the relationship between indicators of corporate social and financial performance within a comprehensive theoretical framework. The results, based on data for 67 large U.S. corporations for 1982-1992, reveal *no* significant negative social-financial performance relationships and strong positive correlations in both contemporaneous and lead-lag formulations.

The relationship between the social performance and the financial performance of business corporations has been a topic of interest and controversy for more than half a century (Dodd, 1932), and serious empirical research on the association between financial and social performance indicators has been going on for several decades. Significant reviews and critiques of this work include Aldag and Bartol (1978); Arlow and Gannon (1982); Aupperle, Carroll, and Hatfield (1985); and Ullman (1985).

Yet in spite of this long record of discussion and analysis, the connection, if any, between corporate social and financial performance has not been fully established. Proponents of the stakeholder theory of the corpo-

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ration argue that favorable social performance is a requirement for business legitimacy and that social and financial performance tend to be positively associated over the long term (Freeman, 1984). Critics, tracing their position back to the classic statement of Friedman (1970), counter-argue that managerial attention to interests other than those of investors is a breach of trust that inevitably reduces the welfare of shareowners. Some of the most comprehensive recent empirical studies have reported conflicting results. Cochran and Wood (1984) found a positive association between social and financial performance, and this result was subsequently confirmed by Spencer and Taylor (1987). However, Aupperle et al. (1985), using very sophisticated social performance indicators, found no relationship at all, and these results were subsequently strengthened by Aupperle and Pham (1989). The methodologically important study of McGuire, Sundgren, and Schneeweis (1988) yielded mixed results and raised more issues than could be answered with the data at their disposal.

The present study addresses the social-financial performance relationship as an empirical issue, not as a matter of corporate governance/legitimacy or business ethics. We frame the research question within a comprehensive typology of possible relationships between corporate social and financial performance, which accommodates all of the arguments and empirical findings presented in the literature. Within this framework, we address this research question: Which relationships between social and financial performance are most frequently observed, and how might the observed relationships best be explained?

THEORY AND HYPOTHESES

The controversy about corporate social-financial performance relationships involves two different empirical issues, in addition to the inevitable problems of measurement. One of these issues is the *direction* of the relationship: Are social and financial performance positively or negatively associated, or not associated at all? (A positive social-financial performance relationship is, of course, a critical implication of the stakeholder theory of the corporation.) The other issue is the *causal* relationship involved: Does social performance influence financial performance; does financial performance influence social performance; or, is there a synergistic relationship (either positive or negative) between the two? Combining these two dimensions of variation yields the six possible causal and

directional hypotheses briefly discussed in the following paragraphs and summarized in Figure 1.

Social Impact Hypothesis (Cell 1)

Some adherents of the stakeholder theory appear to believe that favorable social performance—that is, meeting the needs of various corporate stakeholders—will ultimately lead to favorable financial performance, and vice versa. Cornell and Shapiro (1987) argue that *failure* to meet the expectations of various nonshareowner 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 their analysis, serving the implicit claims of major stakeholders (e.g., employees, customers) 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. This "social impact" version of the stakeholder theory implies a lead-lag relationship between social and financial performance; external reputation (favorable or unfavorable) develops first, then financial results (favorable or unfavorable) follow. Previous statistical tests of this hypothesis have not produced supportive results (McGuire et al., 1988; Preston, Sapienza, and Miller, 1991). Nevertheless, we retain the hypothesis here for completeness.

Hypothesis 1: Higher (lower) levels of social performance lead to higher (lower) levels of financial performance.

Trade-Off Hypothesis (Cell 2)

The trade-off hypothesis asserts that social performance is the independent variable and that social accomplishments involve financial costs. This hypothesis reflects the classic Friedman position and is supported by the well-known early finding of Vance (1975) that corporations displaying strong social credentials experience declining stock prices relative to the market average. More recently, the trade-off hypothesis has been carefully articulated by Aupperle et al. (1985). They point out that socially responsive activities (e.g., charity, environmental protection, community development, etc.) may siphon off capital and other resources from the firm, 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 competitors and/or other norms.

<i>Causal Sequence</i>		<i>Direction</i>	
		<i>Positive</i>	<i>Negative</i>
Social Performance	↑	(1) <i>Social Impact Hypothesis</i> CERESP (8) PEOPLE (10) PSQ (7)	(3) <i>Tradeoff Hypothesis</i> CERESP (0) PEOPLE (0) PSQ (0)
Financial Performance	↑	(2) <i>Available Funding Hypothesis</i> CERESP (9) 7 PEOPLE (10) 7 PSQ (10) 2	(4) <i>Opportunism Hypothesis</i> CERESP (0) PEOPLE (0) PSQ (0)
Social Performance	↔	(5) <i>Positive Synergy</i> CERESP (8) 3 PEOPLE (10) 3 PSQ (10) 8	(6) <i>Negative Synergy</i> CERESP (0) PEOPLE (0) PSQ (0)

Figure 1: Typology of Possible Social-Financial Performance Relationships and Summary Results*

Note. CERESP = Community and Environmental Responsibility, PEOPLE = Ability to Select and Retain Good People, PSQ = Quality of Products and Services.
 * Number of significant results in parenthesis; number of triads in which indicated measure was strongest in boldface.

Hypothesis 2: Higher (lower) levels of social performance lead to lower (higher) levels of financial performance.

Available Funds Hypothesis (Cell 3)

A third possibility is that social and financial performance are, indeed, positively associated, but that the causal or lead-lag relationship is from financial to social performance. Although firms may wish to follow the normative rules of good corporate citizenship at all times, their actual behavior may depend on the resources available. Hence, profitability in one time period may increase a firm's ability to fund discretionary projects, including social performance projects, subsequently. Again, a lead-lag relationship, this time with financial performance leading social performance, would provide a relevant test of this proposition. In the previous lead-lag studies, McGuire et al. (1988) found a stronger positive relationship when financial performance was viewed as the leading variable, and their results were partially supported by Preston et al. (1991). Kraft and Hage (1990) found that the availability of slack resources (i.e., previous profits), as well as the values and goals of managers, strongly influenced the level of community service undertaken by corporations. We explore these lead-lag relationships in our third hypothesis.

Hypothesis 3: Higher (lower) levels of financial performance lead to higher (lower) levels of social performance.

Managerial Opportunism Hypothesis (Cell 4)

It is frequently argued in the literature that corporate managers may pursue their own private objectives, to the detriment of both shareowners and other stakeholders (Weidenbaum and Vogt, 1987; Williamson, 1967, 1985). Recent surveys support the view that top managers consider their own interests of primary importance, or second only to those of customers, in corporate decision making (Posner and Schmidt, 1992; Alkhafaji, 1989). The "managerial opportunism" hypothesis, which we believe to be original here, states that pursuit of private managerial goals, in the context of compensation schemes closely linked to short-term profit and stock price behavior, might lead to a negative relationship between financial and social performance. The reasoning is as follows: When financial performance is strong, managers may attempt to "cash in" by reducing social expenditures in order to take advantage of the opportunity to increase their

own short-term private gains. Conversely, when financial performance weakens, managers may attempt to offset, and perhaps appear to justify, their disappointing results by engaging in conspicuous social programs.

Hypothesis 4: Higher (lower) levels of financial performance lead to lower (higher) levels of social performance.

Positive or Negative Synergies

It is possible, of course, that social and financial performance are synergetic, or at least that the time-pattern of their interaction (whether positive or negative) cannot be detected from available statistical data. We include these possibilities in two additional hypotheses.

Hypothesis 5: There is positive synergy between financial performance and social performance.

Hypothesis 6: There is negative synergy between financial performance and social performance.

DATA AND METHODOLOGY

These hypotheses are investigated with a combination of data from *Fortune* magazine and COMPUSTAT. Since 1982, *Fortune* has conducted an annual corporate reputation survey of several thousand executives, directors, and analysts, covering the largest firms in a number of industries. (The precise number of firms, industries, and respondents has varied over time.) The reliability of this data has been discussed elsewhere, and the general consensus seems to follow Cottrill's conclusion that these data offer "reasonable (reliable and valid)" indicators of corporate social performance (Cottrill, 1992, p. 17). One indication of reliability is that the reputation ratings for individual companies change slowly over time; correlations between individual ratings from year to year are typically .9 or better. Other research has also shown significant associations between these ratings and other evidence, both favorable and unfavorable, of corporate personnel practices, legal problems, and so forth (cf. Preston et al., 1991, fn. 3, p. 163).

The *Fortune* survey gathers data on corporate reputation along eight dimensions, encompassing financial, social, and other aspects of corporate performance. We have selected the three social performance reputation ratings for analysis:

Community and Environmental Responsibility (CERESP),
 Ability to Select and Retain Good People (PEOPLE),
 Quality of Products and Services (PSQ).

These three survey dimensions are taken to reflect the interests of three important stakeholder groups—employees, customers, and the community at large.

As evidence of the financial performance side of the relationship, we have followed McGuire et al. (1988) in the use of traditional financial performance indicators selected from COMPUSTAT:

Rate of return on assets (ROA),
 Rate of return on equity (ROE),
 Rate of return on investment (ROI).

These data series are, of course, much more unstable over time than the reputation ratings.

Our statistical analysis utilizes reputation and financial data for the 67 companies that have been rated in every survey over the 11-year period, 1982 and 1992, and for which the requisite financial information is also available. We test our hypotheses by computing correlation coefficients between the social and financial performance variables, in both contemporaneous and lead-lag combinations, for these 67 firms. Designating each focal year as Year 2, we compute three correlation coefficients:

Contemporaneous: Financial indicator (Year 2) versus Social indicator (Year 2);
 Finance lead: Financial indicator (Year 1) versus Social indicator (Year 2);
 Finance lag: Social indicator (Year 1) versus Financial indicator (Year 2).

These three statistics are computed for each of the three social performance indicators and each of the three financial measures, for each of the 10 year-to-year pairs, yielding 270 test statistics in all. (We omit the 1982 correlations from our analysis, because the data do not permit computation of corresponding lead-lag statistics.)

Contemporaneous correlations are relevant both as indicators of the *direction* of social-financial performance relationships and as reference points against which to compare the lead-lag results. In the lead-lag analysis, our test criterion is that the strongest (magnitude and significance) of the three test statistics in each triad indicates the most important relationship.

RESULTS AND ANALYSIS

The most striking result of these computations is this: Out of the 270 correlations computed, in both contemporaneous and lead-lag form, among the three social and three financial performance indicators there is not a single significant *negative* result. Thus, in this rather extensive set of data covering an 11-year time period, there is *no support* for the trade-off, managerial opportunism or negative synergy hypotheses. On the contrary, *all* of this evidence suggests that there is a *positive* association between social and financial performance in large U.S. corporations and hence is broadly consistent with the stakeholder theory.

This important research finding is independent of the financial performance measure used, and in order to simplify our presentation we focus on results using the return on assets (ROA) measure. Of the 90 correlation coefficients computed for the ROA measure, 82 fall between .30 and .65 and are significant at the .05 level or better. (The additional 3 contemporary coefficients for 1982 are also positive and significant.) These statistical results are displayed in Table 1.

Our lead-lag analysis involves comparison of each triad of test statistics. For example, for the CERESP variable for 1983, the three results are

Contemporaneous	.4715**
ROA lead	.4952**
ROA lag	.4038**

Because the "ROA lead" correlation is the highest of this triad, we take this as providing strongest support for Hypothesis 3 ("available funds").

Several qualifications to this mode of analysis should be mentioned. First, there are probably some "halo effects" among the reputation ratings, and some of the underlying data are known to be serially correlated. Hence, the individual data points used to compute these correlation coefficients cannot be assumed to be entirely independent. In addition, the interpretation of differences in numerical value among correlation coefficients that are themselves of equal significance is an unsettled issue in statistical theory. For purposes of analysis, we take all significant numerical results at face value.

Results of our analysis of the 30 triads of test statistics for ROA are summarized, according to our theoretical schema, in Figure 1. Although all three positive association hypotheses are supported by these results, the social-lead/finance-lag correlation is *never* the highest significant figure in a triad. The "available funding" hypothesis is most strongly

Table 1
Correlation Between Social Performance Indicators and Return on Assets (all results are positive)

Year	CERESP			PEOPLE			PSQ		
	Contemporaneous	ROA Lead	ROA Lag	Contemporaneous	ROA Lead	ROA Lag	Contemporaneous	ROA Lead	ROA Lag
1982	.4270**	.4952**	.4038**	.5251**	.5442**	.4406**	.3687*	.3391*	.2543
1983	.4715**	.3978**	.3623*	.5420**	.5904**	.4734**	.3132*	.3350*	.2560
1984	.2621	.2640	.2397	.5371**	.5667**	.4080**	.2999*	.3182*	.3321*
1985	.3303*	.3778**	.2870*	.5509**	.5601**	.4658**	.4156**	.4401**	.3587*
1986	.4583**	.4473**	.3700*	.5690**	.5487**	.5049**	.4576**	.4311**	.3890**
1987	.3956**	.3807**	.2106	.5690**	.5410**	.3424*	.4373**	.4310**	.3972**
1988	.3375*	.4430**	.3769**	.4486**	.4113*	.4289**	.4613**	.3810**	.3972**
1989	.4418**	.4990**	.3239*	.6019**	.6410**	.4510**	.5513**	.4042**	.4792**
1990	.3611*	.3813**	.3036*	.5035**	.5221**	.3667*	.4728**	.5831**	.4381**
1991	.3147*	.3599*	.4064**	.3915**	.4220**	.5172**	.3473*	.4878**	.3369*
1992	.2808			.4258**			.3382*	.3653*	.4482

Note: CERESP = Community and Environmental Responsibility, PEOPLE = Ability to Select and Retain Good People, PSQ = Quality of Products and Services, ROA = return on investment.

*Significant at .05 level. **Significant at .01 level.

supported in 16 of the 30 tests, and contemporaneous positive correlations are highest within each triad in 14 cases.

CONCLUSION

This research makes three distinct contributions to the literature on corporate social and financial performance.

First, we offer a comprehensive map of all possible empirical social-financial performance relationships and provide a theoretical explanation for each of them.

Second, employing the largest longitudinal database used to date in this type of research, we find overwhelming evidence of a positive relationship between social and financial performance indicators in a sample of large and important U.S. corporations—a finding broadly consistent with the stakeholder theory of the corporation.

Third, among the three possible explanations for a positive social-financial performance relationship, we find the strongest evidence that financial performance either precedes or is contemporaneous with social performance. This means that social-financial performance correlations are best explained either by positive synergies or by “available funding.”

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