

Investigate and Critically Assess the Dimensions and Importance of the Relationship between Corporate Governance and Corporate Social Responsibility

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Abstract

The paper aims at understanding the relation between corporate governance (CG) and corporate social responsibility (CSR). In theory, CG refers mainly to the mechanisms which protect shareholders and other stakeholders and ensure an effective working of the firm, whilst CSR refers mainly to the objective function of the firm and the attention for various stakeholders. The paper discusses these concepts, with particular attention to the relation between CSR and profit maximization. This relation is important to evaluate which actions are truly socially responsible and which actions is simply profit maximization in disguise. The available empirical evidence shows that both CG and CSR are positively related to the market value of the firm. This suggests that in the long run the market mechanism should be able to provide additional resources to those companies which are best at maximizing a widely defined bottom line.

Keywords: corporate governance, corporate social responsibility, relationship.

Introduction

There is increasing attention to the global impact of large corporations. The global impact includes both economic and social elements. Wealthy economies are not willing to massively accent the decisions made by firms, especially when these amount to inflicting costs to society. A few decades ago, companies could pollute environment with no punishment, and still be considered as beneficial to the community in their role of job providers. Today, there are rules which are sometimes implemented so strictly as to threaten the survivorship of misbehaving companies. Social communities try to influence firms in their normal operations from a variety of points of view, including their goals, transparency and code of behaviour. This influence is exerted by means as diverse as legislation, regulation, pressure groups, political contacts.

In such a complex environment, it is natural that firms react by upgrading their working mechanisms. For example, specific sectors or groups of firms can voluntarily overcomply with external rules by issuing codes of behaviour severely restricting certain aspects of their operations. The existence of such voluntary codes may be justified as a credible proof that they want to behave in an acceptable way from the point of view of the community. This paper is concerned with two of the mechanisms used by firms to regulate their operations, known as corporate governance (CG) and corporate social responsibility (CSR).¹ CG is a well-defined concept related to profit maximization and protection of those economic agents who have provided capital to the firm (mainly shareholders). CSR is defined less precisely.

It evokes a concept apparently in contrast with profit maximization because it suggests a set of actions, which is beneficial to some external stakeholders and may conflict with the interest of the shareholders. However, in practice CSR may not be in contrast with profit maximization, as proven by the existence of many companies, which are proud to present themselves as organisations doing well and doing good at the same time. However, how do we know that these companies, which retrieve benefits from these claims, are really behaving in a socially responsible way? What criteria are required in order to consider a corporate action as a responsible one? If a negative impact on total profits is not required to characterize an action as a responsible one, then how do we know that claims of socially responsible behaviour are not simply a disguised form of publicity?

¹ Anderson, K.L. and Yohn, T.L. (2001) The effect of 10.k restatements on returns and information asymmetry, working paper, Georgetown University.

Perhaps companies which are not very active and visible in terms of CSR are simply companies with few occasions to make profitmaximising choices which incidentally are good for other stakeholders. Perhaps, companies which are more visible from the point of view of being socially active really do not care about external stakeholders and are both more lucky or good at finding projects with socially good effects and prompter to communicate these projects to the world.

There is a second issue. Suppose that one accepts the view that CSR is in contrast with profit maximization. Then a contradiction would arise: managers who have been hired to maximize the value of the firm would behave unethically by being socially responsible. They would increase the welfare of some groups of stakeholders at the expense of the welfare of shareholders. This paper claims that there is no contradiction. The relation between CSR and profit maximization is best interpreted by abandoning the standard view of the firm as a shareholder value maximizer and embracing to the more recent view of the firm as a stakeholder value maximizer. (Alden 2002 22). This paper therefore investigates and critically assesses the dimensions and importance of the relationship between corporate governance and corporate social responsibility.

Discussion

Corporate Governance

Corporate governance may be interpreted as a reaction to agency problems, associated with the separation between owner's and managers. Managers act in the partial pursuit of their personal goals and use inefficiently (from the point of view of the owners) the available resources under circumstances not regulated specifically by the signed contracts. Typical examples of this are excess size of the firm built to extend the power of the managers, excess remuneration paid to the top management, expropriation of shareholders by means of pyramid scheme and transfer pricing, resistance to replacement on the part of the managers, therefore establish that "at the most basic level a corporate governance problem arises whenever an outside investor wishes to exercise control differently from the manager in charge of the firm". (Arora 1995 289). Problems are not restricted to the interaction between managers and owners, but may also occur in the relations among owners, especially when they are very heterogeneous in terms of relevance.

There are various cases where minority shareholders lose from the actions of majority shareholders who exploit their control power. Therefore CG can be defined more generally as "a set of mechanisms through which outside investors protect themselves against expropriation by the insiders". Shleifer and Vishny (1997) claim that "the fundamental question of corporate governance is how to assure financiers that they get a return on their financial investment" (Becht 2003 1-126). Therefore CG is a complex issue. It involves problems between owners and managers, between owners themselves and between stakeholders. There is a CG problem whenever one or more groups of stakeholders coordinate their actions in order to increase their benefits at the expense of the benefits of the other stakeholders. (Cremers 2003 15). It is no wonder that in complex companies CG is such a crucial issue. There are various tools to ensure an effective CG. It is possible to distinguish between internal and external tools. Among the most important internal tools, one can include concentration of control rights in the hands of a small number of shareholders who have the incentive to monitor the managers, efficient mechanisms for the formation of the board of directors, remuneration structures for managers which are anchored to performance.²

Among external tools, one can think of control of outside stakeholders, especially banks and financial institutions, and the takeover threat from other firms, which may impose discipline on the managers whenever they do not maximize the value of the company. Are these tools effective? Empirical analyses show that the answer is often positive. (Payne 2003 96). La Porta et al. study the impact of the legal protection of minority shareholders and of the share of the cash flow controlled by the majority shareholder on the value of the firm and find a positive relation. Cremers and Nair find that firms with strong internal and external governance produce a higher (10-15 per cent) return to shareholders than firm characterized by weak governance. Drobetz et al. find a positive association between governance indicators and value of the firm in Germany. Smith claims that the inclusion of a firm in the list of CalPERS (California Public Employee's Retirement System) has important impacts on the corporate governance structure of the firm (70 per cent of the included firms act to improve their CG structure) under observation and on the market value, even though there are few effects on operating cash flows.

² Benston, G., Bromwich, M., Litan, R.E. and Wagenhofer, A. (2003) Following the money, AEI-Brookings Joint Center for Regulatory studies, Washington, DC. Pp. 24

The cost-benefit analysis is positive for CalPERS: in the period 1987-1993, activism costs \$3.5 million but the benefit is \$19 million. (Williamson 1985 24). There are, however, exceptions. Even single reference shareholders may fail to maximize the value of the company and may even damage minority shareholders and stakeholders in general, as the Parmalat case has shown in 2003, an episode which points out the relevance of the legal protection of the votes discussed by Shleifer and Vishny. Even shareholders' activism has not been found to be very effective. There are many discussions about boards of directors and the role of independent directors, for example, connected with the role of the CEO of the corporation for his election. Empirical evidence on the effectiveness of independent directors is mixed. According to many, compensations connected with the value of the firm has been one of the main incentives for the burst of "creative accounting" of the second part of the 1990s with the subsequent problems.

Moreover, on average the sensitivity of managers' wage to change in wealth of shareholders is low. Bank control has not been particularly effective in Germany and Japan - the most important contemporary experiments - and may actually give rise to inefficiencies if the criteria used by banks to provide loans are affected by the existence of ownership. Takeovers are very infrequent: Becht et al. show that in the U.S. the takeover rate has been infrequently above 1.5 per cent and the hostile takeovers are in general 30 per cent of the total takeovers. There are good reasons for this, connected with the high costs of acquisitions. Also the impact of active institutional shareholders is unclear: Gillan and Starks find little impact of resolutions on operating income and some impact on CG. (Romano 2001 174). Black is a pessimist and claims that "a small number of American institutional investors, mostly public pension plans, spend a trivial amount of money on overt activism efforts. The current available evidence is consistent with the proposition that the institutions achieve the effects on firm performance that one might expect from this level of effort - namely, not much".

In conclusion, CG has become a crucial issue, but there does not seem to be a perfect recipe for implementing tools which ensure the best possible CG. The complexity of organisations allows many possibilities for illegal behaviour on the part of some stakeholders. Moreover, it is always very hard to tell the cases where stakeholders are really interested in the value of the firm from cases where stakeholders pursue a personal objective. The many externalities associated with the efficient working of the firm are also a deterrent for costly and serious involvement on the part of various groups. (Shleifer 1997 737).

Corporate social responsibility

From a definitional point of view, CSR is in some sense the opposite of CG: there are thousand of case studies but few theoretical discussions. The few existing definitions are perhaps too general and far from theory. The Commission of the European Communities defines CSR as a concept by which "companies decide voluntarily to contribute to a better society and a cleaner environment". It also says that behaving in a socially responsible way amounts to "going beyond compliance and investing 'more' into human capital, the environment and the relations with stakeholders". In the OECD Guidelines for Multinational enterprises, The Organization of Economic cooperation and Development claims that "the common aim of the governments adhering to the Guidelines is to encourage the positive contributions that multinational enterprises can make to economic, environmental and social progress, and to minimize the difficulties to which their various operations may give rise".

This may be generalized by referring to the concept of business ethics, discussed at length by Payne in *Value Shift: why companies must merge social and financial imperatives to achieve superior performance*. (Payne 2003). Hopkins claims that "CSR is concerned with treating the stakeholders of the firm ethically or in a responsible manner. Ethically or responsible means treating stakeholders in a manner deemed acceptable in civilized societies". If the firm is regarded as a living organism, then it is natural to believe that good firms will behave in an ethical and socially responsible way, and will try to induce an ethical behaviour on the part of its employees. (Palmrose 2002 18). These definitions stress the equivalence between CSR and ethics and, surprisingly, do not explicitly refer to the link between CSR and profit maximization. The presumption of the previous definitions is that CSR negatively impacts profits: behaving responsibly may be costly (in terms of utility) to an individual with a low level of ethics, so that behaving in a socially responsible way may be costly (in terms of profits) to a firm. Investing 'more' into human capital and the environment may well decrease profits, and the same happens in terms of contributing to a better society. (Commission of the European Communities 2002 47). Indeed, if these objectives were achievable in the normal search for profit maximization, one doubts that firms would need the idea of CSR at all. (Karpoff 1993 757).

To analyse CSR more systematically, and to study the relation between CSR and profit maximization, it is useful to discuss the motivations behind various cases of responsible behaviour on the part of the firm:

- (i) managers may decide that the firms behave in a socially responsible way at the expense of profits in order to retrieve private interest, associated with the rewards that the community may ensure to the promoters of the responsible behaviour of the company;
- (ii) managers may decide that the firms pursue profit maximization but exploit actions, which are incidentally also in the interest of some group of stakeholders to claim a socially responsible behaviour;
- (iii) managers may decide that the firm must be socially responsible, even at the cost of deviating from profit maximization and without increasing their private utility.³

It is claimed that cases (i) and (ii) represent opportunistic behaviour. Case (i) is sufficiently clear and does not warrant a particular discussion. Case (iii) deserves more attention, because it may hide a paradox: managers pursuing CSR at the expense of profit maximization would behave unethically from the point of view of not respecting the contracts which they have signed with the owners of the firm, unless the socially responsible behaviour was dictated by the owners themselves. (Leuz 2003 505). Shareholders and other stakeholders may have divergent goals, and it is unclear why managers should choose to follow the former, even though there are reasons proposed by Williamson (shareholders are less protected than others and their work is sunk into the firm) and Hansmann (shareholders may better coordinate among themselves and produce a better decision process). Therefore, profit-decreasing CSR may be justified by the existence of agency problems and incomplete contracts which undermine the basic idea of shareholders' leadership. (Bhagat 2001 231).

Viewing CSR in this enlarged framework is essential in order to properly evaluate practical cases. If profit maximization is taken as the basic goal of the firm, then it may be difficult to both find true examples of CSR and justify managers pursuing CSR. (Margolis 2001 47). Under these circumstances in fact any socially responsible action would be taken in response to a need of a stakeholder and would imply a profit-decreasing choice on the part of the managers. However, under a more general view of firms as stakeholders' interest maximizers, managers may try to reconcile the objects of both shareholders and other stakeholders, taking actions which are compatible with a win-win scenario where both profits and welfare improve. In this case, it may be perfectly sound to find many projects, which increase profits and at the same time benefit other shareholders. (Orlitzky 2001 369)

Empirical results about CSR

There are two relevant pieces of evidence. The first is related to direct and indirect analyses of the effect of CSR on firms' profits, and the second to the performance of the socially responsible investments. These two pieces of evidence are relevant because they look at two different angles of the value creation process, that is the cost to the supplier of social responsibility (the firm) and to the demander of the same good (the investor). (Hopkins 2004 55)

The direct cost of CSR

Starting from the supply side, Payne claims that risk management is one of the goals of corporations' ethics; by upgrading the ethical and social values of the corporation and its employers one may hope to minimize the cases of bad behaviour and the potentially negative consequences on the value of the firm. For example, the Shareholder Action Network (SAN) accuses ExxonMobil of weak sensitivity (worse than the average of the industry) to issues like climate change and alerts to the possibility that there are risks connected with future claims on the part of stakeholders who in the future may be damaged by climate change and consequently by the lack of action of the company. In this case, CSR is positively related to the value of the firm from the point of view of minimizing future possible liabilities associated with lack of social responsibility. (Hamilton 1993 62). Another positive effect of CSR and ethical values is associated with improvements in organisations through innovation, cooperation, motivation on the part of the workers, branding of the corporation in the relevant market by constructing a special relationship with the stakeholders, especially clients and intermediate suppliers.

³ Black, B.S. (1998) 'Shareholder activism and corporate governance in the United States', in P. Newman (eds), *The New Palgrave Dictionary of Economics and the Law* 3: 459-465.

Whilst it may be difficult to place a value on the reputation of the firm in terms of CSR, indirect evidence is available. Karpoff and Lott show that the decrease in share prices following news about illegal actions on the part of the firm is largely associated with damage to reputation, only 6 percent is associated with the objective estimate of the damage. Anderson and Yohn find that the stock market reacts with a negative return of almost 4 percent to news about the necessity of income restatements. (Heal 2004 14). Palmrose et al. propose a similar analysis for the period 1995-1999 and find an even larger estimate of 9 per cent, with an even lower return in cases of illegal behaviour on the part of the management. Elayan et al. analysed the reaction of stock prices to news of accounting irregularities and find an effect of 25 percent in 3 days following the announcement, 5 per cent in 90 days preceding the piece of news, 60 per cent in the overall period of 180 days surrounding the event. The reaction is connected with the existence of informational asymmetries, for example, in the case of small firms and high tech firms and in those firms where the management is perceived as receiving a higher salary, probably because in those cases there is a higher probability that the management is trying to expropriate the other stakeholders. There are various studies also on the direct relation between CSR and firm value. (Geczy 2003 24)

The cost of socially responsible investment

The previous paragraph has shown that CSR may not necessarily be a cost to the firm. On the contrary, there are theoretical reasons to believe that CSR may have a positive impact on value, and empirical analyses showing the existence of a positive relation. On the basis of this evidence, one would expect to find little or no cost also from the point of view of the financial investor following principles of social responsibility. The available evidence shows that this is indeed the case. (Gillan 2000 275). One way to understand this is to look at socially responsible indices of stock performance. Three important indices are the Domini 400, started in 1990 and based in the U.S. market, the Dow Jones Sustainability Index started in 1999 and the more recent FTSE4Good, started in 2001. The three indices are based on partially different inclusion criteria: Domini excludes some specific sectors on the basis of the estimate of their social damage, Dow Jones Sustainability Index does not discriminate on the basis of belonging to a specific sector but only includes firms which satisfy minimum requirements as far as issues like environmental sustainability and human rights are concerned. (Gregory 1997 705).

Corte compares the historical performance of such indices with comparable indices from the point of view of average return and volatility of return. The results show that the socially responsible indices behave better than the respective benchmarks. For example, the social index Ethibel World over the period 1998- 2003 had an average return (2.25 per cent) superior to that offered by the index MSCI World (0.54 per cent) and a higher volatility (21 per cent against 19 per cent). The Dow Jones Sustainability Index produced an average return of 1.72 per cent (with a volatility of 21 per cent) over the same period against 1.42 per cent (with a volatility of 20 per cent) of the Dow Jones Global. In 1990-2003 The Domini Social on average increased by 13 per cent with a volatility of 16per cent against values of 12 per cent and 15 per cent for the S&P500. There are of course exceptions: the FTSE4Good decreased 14 per cent in 2001-2003 with a volatility of 23 per cent against a decrease of only 12 per cent (with a volatility of 22 per cent) for the FTSE Europe. However, what is relevant is that there does not seem to be any systematic downward bias in the return of the socially responsible indices with respect to appropriate benchmarks. Actually, a performance analysis based on the three factor Fama and French model reveals that the SRI indices in general overperform the benchmarks when one takes into account the systematic risk associated with size and value effects. (Financial Executives International 2001 27). Other empirical analyses, conducted on the basis of the performance of socially responsible mutual funds, produce similar results. An early study is Grossman and Sharpe which looks at the financial implications of discrimination against firms which at the time did business with South Africa. The authors show that the socially responsible portfolio produces a return 0.26per cent higher than the benchmark for the stock market, which is reduced to 0.19 per cent with a risk correction to take account of larger investment in small firms. More recently, Geczy et al. show that the opportunity of limiting the investment universe to SRI funds is negligible if the goal of the investor is replicate the performance of the market index, and becomes substantial (3.6per cent) only when the investor wants to do active fund management. (Elayan 2002 7).

Conclusions

The corporate sector has been under attack along two lines. First there is the perception that the simple drive for profit maximization may be bad for society as a whole because of some negative by products on the environment, human rights, workers condition and other elements. Second there is the realisation that some part of the corporate sector has not been following the basic rules and has illegally extracted resources from stakeholders.

In some sense, these attacks arise from failures of both corporate governance and corporate social responsibility. An effective corporate governance system would prevent illegal actions against stakeholders. An effective socially responsible corporate code would prevent actions which are legal but inappropriate because of their consequences on some of their shareholders. Corporate governance and corporate social responsibility are therefore complementary in their shaping of the objective function and the constraints faced by corporations. They can reinforce each other in the modern vision of the firm as an institution which does not disregard various relevant constituencies in its search for increases in value.

The modern and socially responsible firm can go beyond the simple definition of accounting profits if it realises that such a definition ignores pieces of value which are practically relevant. It does not matter whether accounting profits neglect negative consequences on the environment, violation of human rights and other elements. These elements are crucial to the evaluation of the corporation which is given by society. Fortunately, the modern environment has an increasing number of tools which may be used to induce corporations to move beyond the traditional bottom line and towards an extended bottom line. Socially responsible firms are often also the most respected and profitable firms. Therefore socially responsible actions are not selected by firms from the pool of profitdecreasing choices. It follows that socially responsible firms do try to maximize profits but at the same time try to improve the welfare of other stakeholders. Firms with a good corporate governance are also more respected and valuable. Therefore a good corporate governance protects the stakeholders which contribute to the life of the firm. Corporate governance and social responsibility are strong complements. The positive relation existing between CG and CSR on the one hand and the market value of the firm on the other hand, suggests that market competition is somehow able to detect the companies which are best also from points of view which are not included in the accounting definition of profit. This is a reassuring hypothesis, which merits more theoretical and empirical analysis.

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