

SHAREHOLDER VALUE, STAKEHOLDER MANAGEMENT, AND SOCIAL ISSUES: WHAT'S THE BOTTOM LINE?

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We test the relationship between shareholder value, stakeholder management, and social issue participation. Building better relations with primary stakeholders like employees, customers, suppliers, and communities could lead to increased shareholder wealth by helping firms develop intangible, valuable assets which can be sources of competitive advantage. On the other hand, using corporate resources for social issues not related to primary stakeholders may not create value for shareholders. We test these propositions with data from S&P 500 firms and find evidence that stakeholder management leads to improved shareholder value, while social issue participation is negatively associated with shareholder value. Copyright © 2001 John Wiley & Sons, Ltd.

INTRODUCTION

Globalization has increased calls for corporations to use firms' resources to help alleviate a wide variety of social problems. The pharmaceutical industry, for example, is asked to donate free drugs and vaccines to Third World nations where the afflicted cannot pay. Firms engaged in manufacturing are encouraged to apply developed nation's laws and norms to issues such as child labor and environmental pollution in less developed countries, regardless of local laws or customs.

These calls for expanded responsibilities for business are intuitively appealing to those who see existing governments as unable or unwilling to deal with such problems. Firms may indeed have resources that could be used to help with issues that are typically dealt with by govern-

ments or other nongovernmental organizations. But, is this the appropriate role for business in society? Should the mandate of business extend beyond its traditional stakeholders (shareholders, customers, suppliers, employees, local communities, and government)? These are essentially normative questions.

Empirical researchers interested in the way firms interact with stakeholders, however, can examine related but somewhat more objective questions. For example, when firms *do* expand their activities beyond those associated with the direct stakeholder relationships, what is the effect on the economic viability that created the wealth of the firm? That is, if the economic success of firms raises societal expectations to consider more than the interests of primary stakeholders when making resource decisions, can firms respond to these social issues *and* continue to be economically viable? In a world of increasingly competitive capital markets, how are a firm's shareholders affected by firm decisions to respond to these increased responsibilities?

Previous literature has studied the relationship between firm financial performance and firm

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social responsibility or social performance (e.g., Aupperle, Carroll, and Hatfield, 1985; Griffin and Mahon, 1997; McGuire, Sundgren, and Schneeweis, 1988; Pava and Krausz, 1996; Waddock and Graves, 1997a) but to date there is no clear empirical relationship. For example, Waddock and Graves (1997a) find a recursive relationship between social performance and financial performance. They find empirical support for both the proposition that social performance leads to improved financial performance and that better financial performance leads to social performance. Do socially responsible strategies create value for shareholders? Or, is social performance a discretionary activity funded by slack cash flow?

The relationship between social performance and financial performance may be better understood by separating social performance into two components: stakeholder management and social issue participation. Corporate social performance (CSP) is a multidimensional construct (Carroll, 1979) that is related to stakeholder management although not synonymous (Clarkson, 1995). We believe a key distinction between the two components of CSP, stakeholder management and social issue participation, pertains to their respective roles in the firm's value creation process. Building better relations with primary stakeholders like employees, customers, suppliers, and communities (Freeman, 1984) could lead to increased financial returns by helping firms develop intangible but valuable assets which can be sources of competitive advantage. For example, investing in stakeholder relations may lead to customer or supplier loyalty, reduced turnover among employees, or improved firm reputation. These valuable assets in turn lead to a positive relationship between stakeholder management and shareholder value wherein effective stakeholder management leads to improved financial performance. Participating in social issues not related to the firm's direct relationship with primary stakeholders, however, may not create similar value for shareholders. Instead, we expect that social issue participation is negatively related to shareholder value. Thus, we posit that shareholder value may be affected differently depending upon the nature or scope of the socially responsible strategy/activity.

In the following section of this paper, we build a theoretical rationale to support these claims and advance our hypotheses. Our theoretical development draws upon existing literature in social per-

formance and stakeholder management as well as the resource-based view of the firm. Next, we use a sample of S&P 500 firms to empirically test the proposed relationships. Finally, we discuss the implications of our results for future research in social performance, stakeholder management, and financial performance as well as for practicing managers.

VALUE CREATION AND DECOUPLING SOCIAL PERFORMANCE

Corporate social performance is a multi-dimensional construct defined by Carroll (1979) as having four components: economic responsibility to investors and consumers, legal responsibility to the government or the law, ethical responsibilities to society, and discretionary responsibility to the community. CSP incorporates the interaction between the principles of social responsibility, the processes of social responsiveness, and the policies and programs designed by corporations to address social issues (Wartick and Cochran, 1985). Despite the lack of a shared precise definition in the literature, CSP is generally conceived as a broad construct comprised of stakeholder management and social issue management (Clarkson, 1995; Swanson, 1995; Wood, 1991).

Stakeholder management

In this paper, we adopt what Mitchell, Agle, and Wood (1997) would classify as a 'narrow' definition of stakeholders in that we consider primary stakeholders as those stakeholders who 'bear some form of risk as a result of having invested some form of capital, human or financial, something of value, in a firm' (Clarkson, 1994: 5). These stakeholders are those without whose participation the corporation cannot survive (Clarkson, 1995). Primary stakeholders include capital suppliers (shareholders), employees, other resource suppliers, customers, community residents, and the natural environment (Clarkson, 1995; Starik, 1995). Clarkson argues that 'primary stakeholder groups typically are comprised of shareholders and investors, employees, customers, and suppliers, together with what is defined as the public stakeholder group: the governments and communities that provide infrastructures and

markets, whose laws and regulations must be obeyed, and to whom taxes and other obligations may be due' (1995: 106). While not all community residents are employees, suppliers, customers or investors, they do provide various forms of important infrastructure for the firm and in turn are impacted directly by tax revenues and physical environmental protection (or degradation).

Clarkson asserts that 'the survival and continuing profitability of the corporation depends upon its ability to fulfill its economic and social purpose, which is to create and distribute wealth or value sufficient to ensure that each primary stakeholder group continues as part of the corporation's stakeholder system' (1995: 107). Thus, an organization can be viewed as a set of interdependent relationships among primary stakeholders (Chakravarthy, 1986; Donaldson and Preston, 1995; Evan and Freeman, 1988; Greenley and Foxall, 1996; Harrison and St. John, 1994; Hill and Jones, 1992; Jones, 1995; Kotter and Heskett, 1992). For example, purchasing a quality product at a reasonable price is a consumer objective. If desired value is not delivered, fewer products will be purchased. This, in turn, affects present and future expectations resulting in lower stock prices, possibly leading to lay-offs, reductions in purchases of inputs from suppliers, and lower taxes being paid by the firm, etc.—negative consequences for all primary stakeholders.

Managing relationships with primary stakeholders, however, can result in much more than just their continued participation in the firm. Effective stakeholder management—relations with primary stakeholders to include customers, employees, suppliers, community residents and the environment—can constitute intangible, socially complex resources that may enhance firms' ability to outperform competitors in terms of long-term value creation.

The resource-based view of the firm (Barney, 1991; Penrose, 1959; Wernerfelt, 1984) contends that a firm's ability to perform better than the competition depends on the unique interplay of human, organizational, and physical resources over time (Amit and Schoemaker, 1993; Barney, 1991; Dierickx and Cool, 1989; Lippman and Rumelt, 1982). Many scholars now argue that intangible, difficult-to-replicate resources must undergird the business processes if a firm is to

outperform its rivals and create value for shareholders (Atkinson, Waterhouse, and Wells, 1997; Barney, 1991; Teece, 1998). Resources that are most likely to lead to competitive advantage are those that meet four criteria: they should be valuable, rare, inimitable, and the organization must be organized to deploy these resources effectively (Barney, 1991). Using these criteria, resources that may lead to competitive advantage include socially complex and causally ambiguous resources such as reputation, corporate culture, long-term relationships with suppliers and customers, and knowledge assets (Barney, 1986; Leonard, 1995; Teece, 1998).

Some strategy researchers have explored the firm as an institutional setting that can facilitate learning and the creation and dissemination of value-producing knowledge (Grant, 1996; Moran and Ghoshal, 1996; Nahapiet and Ghoshal, 1998; Spender, 1996). This institutional context can include, for example, a history of repeat dealings with actors such as employees, customers, suppliers, and local communities that generate reputational capital and trust (Barney and Hansen, 1994; Ring and Van de Ven, 1992, 1994).

By developing longer-term relationships with primary stakeholders like customers, suppliers, and communities, as well as present and future employees, firms expand the set of value-creating exchanges with these groups beyond that which would be possible with interactions limited to market transactions. Our emphasis here is on the value that can be created by interactions, between firms and primary stakeholders, which are *relational* rather than *transactional* since transactional interactions can be easily duplicated and thus offer little potential for competitive advantage. Relationships involve investments by both (or multiple) parties and thereby include a time dimension; reputation is important and fair dealing and moral treatment by both (or multiple) parties enhance the value of relationships.

Harrison and St. John (1996) describe examples of 'webs of interdependencies [that can be] created among stakeholders' as organizational means to deal with increasingly uncertain and competitive environments. Cooperation among competitors and other firms operating in geographic locales to support infrastructure investments in communities are relational transactions that lead to value creation (Hart, 1995; Sharma and Vredenburg, 1998). Other examples of activities con-

sistent with long-term value creation through relationships with key stakeholders are cooperative planning and design efforts that unite firms with suppliers and customers and rewarding managers/employees on the basis of customer satisfaction measures or other measures of external reputation (Lado and Wilson, 1994; Martin, Mitchell, and Swaminathan, 1995; Mudambi and Helper, 1998; Nayyar, 1995; Oliver, 1988; Rao, 1994). Because of the relational aspects that underlie these activities, the time dimension will constitute an important, intangible, path dependent quality of the relationship with that stakeholder group. In turn, these relationships will be difficult for other firms to duplicate at least in the short run.

We are not alone in emphasizing the importance of improving relations with primary stakeholders as competition increases. Chakravarthy (1986), Pfeffer (1998), and Prahalad (1997) express similar views and Jones (1995) in his instrumental stakeholder theory contends that firms that contract with their primary stakeholders on the basis of mutual trust and cooperation will have a competitive advantage over firms that do not, all else equal. Therefore, we propose the following:

Hypothesis 1: Stakeholder management is positively associated with shareholder value creation.

Next, we address the question of causality. If effective stakeholder management is positively associated with financial performance, in what direction is the causality? The primary stakeholder interdependence perspective holds that effective stakeholder management leads to financial performance. Firms can be more successful by developing (up to some margin) relationships with customers, employees, communities and governments (Harrison and St. John, 1994; Kotter and Heskett, 1992).

This sentiment is reflected by Robert Wood Johnson (quoted in Preston and Sapienza, 1990), who led Sears in its postwar growth, when he listed 'four parties to any business in order of importance' as 'customers, employees, communities, and stockholders.' He contends that if the interests of the first three groups are looked after, then the stockholders benefit. Similarly, Kaplan and Norton (1996) argue that the drivers of fi-

nancial performance are the relationships a company develops with customers and the relationships internal to the firm that shape customer relations and impact customer service. Legnick-Hall (1996) emphasizes the importance of loyalty-producing relationships with customers that extend beyond traditional firm boundaries as a source of competitive advantage. Atkinson *et al.* (1997) argue that employees and communities should also be included in this list of relationships that drive financial performance, such that effective stakeholder management with primary stakeholders is seen as driving financial performance. Bennett Stewart, creator of the financial management system based on Economic Value Added (EVA), argues that 'to increase shareholder value, a company must address the needs of its stakeholders more efficiently and effectively than the companies against which it competes' (Birchard, 1995: 49). Therefore, we propose the following:

Hypothesis 2: Stakeholder management leads to improved shareholder value creation.

Social issue participation

If stakeholder management is positively related to shareholder value creation and the nature of causality is such that effective stakeholder management leads to improved shareholder value creation, does this relationship also extend to another component of corporate social performance—social issue participation?

We have suggested above that investing in relationships with primary stakeholders can lead to valuable, intangible competencies that are important in gaining and maintaining competitive advantage. Using corporate resources to pursue social issues that are not directly related to the relationship with primary stakeholders may not create such advantages. Social issue participation refers to elements of corporate social performance that fall outside of the direct relationships to primary stakeholders. For example, common forms of social issue participation may include: avoiding nuclear energy, not engaging in 'sin' industries (alcohol, tobacco, and gambling), refraining from doing business with countries accused of human rights violations, refusing to sell to the military, etc. While each of these may be an important issue for some members of society, the fundamental difference between social issue participation

and stakeholder management is the absence of direct ties to the relationships between the firm and its primary stakeholders. That is, social issue participation may be characterized as pertaining to a more 'broad' definition of social responsibility beyond the primary stakeholder exchange (Mitchell *et al.*, 1997) that recognizes companies can be affected by or affect almost anyone.

Normatively some groups (even within the company) may desire taking stances on such issues, but participation in such does not necessarily provide the basis for value creation that stakeholder management does. For example, while the gambling industry may be viewed as undesirable by a segment of society, firms that choose not to be in this industry are not necessarily making a decision that could provide for sustained competitive advantage. Other firms could easily make the same choice not to participate. Choice of industry or overseas investment locations in themselves cannot provide for the intangible sources of competitive advantage so important in today's competitive landscape. Similarly, an international corporate giving program may provide some value to shareholders in the form of tax deductions. However, tax advantages are readily duplicated by other firms and, therefore, this type of advantage cannot provide the basis for competitive advantage. Thus, we contend that the very nature of the relationship between shareholder value and social issue participation could be different from that with stakeholder management because of the lack of a link to important underlying sources of competitive advantage for the firm.

Thus, we propose the following:

Hypothesis 3: Social issue participation is negatively related to shareholder value creation.

Hypothesis 4: Social issue participation leads to decreased shareholder value creation.

METHODS

Variable operationalization

Shareholder value creation is operationalized as Market Value-Added, or MVA. MVA was chosen because it is a measure that captures the relative success of firms in maximizing shareholder value through efficient allocation and management of

scarce resources. MVA is calculated as:

$$\text{MVA} = \text{market value} - \text{capital}$$

where market value refers to the equity market valuation of the company and capital refers to the debt and equity invested in the company. MVA is simply the difference between the cash that both debt and equity investors have contributed to a company and the value of the cash that they expect to get out of it. Essentially, MVA is the stock market's estimation of net present value. Thus, MVA is unique in its ability to capture shareholder value creation because it captures both the valuation (the degree of wealth enrichment for the shareholders) and performance (the overall quality of capital management) (Stern Stewart, 1996). We use MVA in our analysis not cross-sectionally, but by examining the change in MVA between one year and the next in order to more accurately reflect changes in the measure that are attributable to events in the prior year rather than total capitalization across time. That is, the measure of MVA for 1996 represents the change in market value added between 1995 and 1996. This operationalization is more appropriate in causal models, such as those we use to test Hypotheses 2 and 4, because it represents not total capitalization that may have to do with events outside the timeframe of interest, but only the portion of MVA that is created/destroyed during our sample.

While many different operationalizations of shareholder value creation, or firm performance, could have been used, we chose MVA for a variety of reasons. First, accounting measures of firm performance are inherently more short term in nature (Briloff, 1972, 1976; Fisher and McGowan, 1983; Hayes and Abernathy, 1980; Ouchi, 1980), tap only historical aspects of performance (McGuire, Schneeweis, and Hill, 1986) and are subject to a great degree of manipulation by managers (Bentson, 1982; Briloff, 1972, 1976; Fisher, 1979; Livingstone and Salamon, 1971; McGuire *et al.*, 1988; Solomon, 1970; Watts and Zimmerman, 1978, 1990). Therefore, accounting measures of performance, such as Return on Assets and Return on Equity, are less useful for the project at hand because they are not successful in capturing the long-term value of the company or value created for shareholders. In addition, accounting measures of performance

have difficulty capturing intangible relationships (Barney, 1991; Dierckx and Cool, 1989; Itami, 1987), such as those with stakeholders. For example, it is extremely difficult to capture the value of customer service or reputation on a balance sheet (Bentson, 1982; Watts and Zimmerman, 1990). Accounting measures of performance are better suited for measuring tangible asset utilization and, thus, are inadequate for capturing the type of performance of interest in this paper—shareholder value creation.

When compared to other market-based measures of shareholder value creation, MVA also has advantages. Lubatkin and Shrieves (1986) and Rappaport (1992) assert that market-based measures of performance are preferable to accounting measures because of the ability to capture the future value of income streams more appropriately. MVA was chosen for this reason and also because MVA is more than just representative of the future stream of income as it takes account of debt and equity invested in the company. It has been shown in finance literature that firms that apply net present value, or NPV, performance measures and invest in positive NPV strategies maximize the wealth of stockholders (Copeland and Weston, 1983). Simple firm calculated NPV measures, however, are also subject to accounting problems regarding the anticipation of future cash flows and discount rates. Therefore, by using MVA, which approximates the stock market's estimation of net present value, subjective accounting issues are avoided.

Another market-based measure that approximates the stock market's estimation of net present value is Tobin's *Q* (Tobin and Brainard, 1968). Tobin's *Q* is calculated by dividing the firm's market value by a firm's asset replacement costs. While Tobin's *Q* is commonly used in strategy research, we have chosen MVA over Tobin's *Q* because the valuation of asset replacement costs in Tobin's *Q* suffers from the same issues identified with many accounting measures of performance—difficulty in valuing intangible assets. Therefore, because shareholder value creation is the performance variable of interest, MVA is the most appropriate choice because it captures shareholder value creation without being subject to accounting measure shortfalls.

MVA data for this study was taken from the Stern Stewart Performance 1000 data base. This is a data base compiled by Stern Stewart Manage-

ment Services, Inc. to track the *Fortune* 1000. In this data base, MVA is calculated based on data available from Compustat.

Stakeholder Management (SM) is a variable that has been rarely quantified. Two exceptions are Greenley and Foxall (1997), who use survey methodology to measure a firm's orientation towards multiple stakeholders, and Waddock and Graves (1997b), who use the Kinder, Lydenburg, Domini (KLD) index as a measure of stakeholder performance. Because our question of interest involves stakeholder management performance outcomes, we were more interested in quantifying this relationship based on firm behavior rather than beliefs and thus turn to the KLD data base for our data.

KLD is a commonly used measure of corporate social performance (e.g., Graves and Waddock, 1994; Ruf, Muralidhar, and Paul, 1993; Sharfman, 1996; Waddock and Graves, 1997a). The KLD index of social performance is compiled by an independent rating service that focuses exclusively on ranking approximately 800 firms (to include the *Standard & Poor's* 500) on a range of nine areas of social performance. These areas include: community relations, employee relations, environmental performance, product characteristics, treatment of women and minorities, military contracting, production of alcohol or tobacco, involvement in the gambling industry, involvement in nuclear energy, and investment in areas involved with human rights controversies. KLD uses a variety of sources to capture these data including annual surveys, annual reports, proxy statements, and quarterly reports, as well as external data sources such as articles in the general business press and agencies. This rating scheme, in addition to being adopted in recent empirical testing of corporate social performance, has been tested for construct validity against other measures of CSP by Sharfman (1996) and has been found to be one of the best measures of CSP available to date.

In order to adapt the KLD measure to capture primary stakeholder management and create a variable SM (stakeholder management), we customized this scale to exclude issues outside of the primary stakeholder domain of CSP. These excluded issues were then used in creating the variable *Social Issue Participation* (SIP). In order to divide these measures into the categories of stakeholder management and social issue partici-

pation, we screened items based on their direct relationship to primary stakeholders. As in the case of the Waddock and Graves (1997b) study, the items for stakeholder management chosen came from five existing categories of the KLD measures: employee relations, diversity issues, product issues, community relations, and environmental issues. These five categories parallel the primary stakeholder groups (other than capital suppliers) for corporations: employees (items from employee relations and diversity issues), customers (items from product issues and community relations), the community (items from community relations, environmental relations and diversity issues), and suppliers to the extent that among the diversity issues are reports of dealings with minority-owned suppliers. Ideally, we would like to have broader measures of supplier relations. While none of these measures captures the full range of relations with these primary stakeholders, each provides some important evidence pertaining to the nature of stakeholder relations with these groups.

The SIP variable includes the KLD categories of Other, Alcohol/ tobacco/gambling exclusionary screens, military exclusionary screens, nuclear power exclusionary screens, and non-U.S. concerns over investment in Burma and Mexico. For individual item components of SM and SIP, please refer to the Appendix.

The KLD categories are rated on a scale ranging from -2 (major concerns), -1 (concern), 0 (neutral), +1 (strength), to +2 (major strength). Each category in the SM and SIP measures is given equal weighting in that each may range from -2 to +2. Prior use of KLD as a measure of CSP has used differential category weightings (Graves and Waddock, 1994; Ruf *et al.*, 1993; Waddock and Graves, 1997a) based on either academic opinion about importance of the categories (Graves and Waddock studies, 1994, 1997) or the analytic hierarchy process (Ruf *et al.*, 1993). However, since theoretical work in stakeholder management and social issues participation has yet to identify a ranking of importance for the various stakeholder groups and issues (and indeed, Mitchell *et al.* (1997) assert that no such universal ranking can be made), we have chosen in this paper to give equal importance to the categories adopted from KLD identified above in order to construct our variables SM and SIP. Given this, we chose to construct our measures

of SM and SIP as gestalt measures and used simple summing of the dimensions of the KLD measure adapted for the study at hand.

Control variables are also included in our analysis to ensure that any relationship found between shareholder value creation, as measured by MVA, stakeholder relations, as measured by SM, and social issue participation, as measured by SIM, are not a result of other confounding variables. Because size has been suggested in previous articles (Ullman, 1985; Waddock and Graves, 1997a) to be a factor that affects both firm performance and the larger construct of CSP, we have included control variables in our analysis for net sales and net income. Size is a relevant variable because size may be related to the urgency and salience of stakeholder relations.

In addition, previous literature has indicated a need to control for industry (Waddock and Graves, 1997a) and risk (Aupperle *et al.*, 1985; Pava and Krausz, 1996; Waddock and Graves, 1997a). Industry and risk are also included as control variables to ensure that differences in MVA across our sample are not merely an effect of industry differences or differences in risk profiles. Industry has been operationalized in this study using the standard 2-digit SIC code. Firm risk has been operationalized using *beta* as reported in *Standard & Poor's*.

Analysis

While ideally an event study methodology would allow us to evaluate changes in shareholder wealth associated with stakeholder management and social issue participation, the multidimensionality of each of the constructs and the lack of discrete events associated with such activities make this methodology difficult. Therefore, we use regression analysis as the primary methodology to test our hypotheses.

Testing of the hypotheses was performed for the years 1996, 1995, and 1994. The change in MVA between 1995 and 1996 is used as our dependent variable in testing Hypotheses 2 and 4. The stakeholder management and social issue behavior measured took place during the year 1994 (reported by KLD in 1995) and the shareholder value measure is that created/destroyed in 1995. We chose to model a lagged effect between our independent variables and our dependent variables because the effect of stakeholder man-

agement or social issue participation is not expected to have an immediate effect on shareholder value and due to reporting practicalities (KLD measures are gestalt measures over the year and not logged as specific timed behavior during the reporting year). We consider it likely, however, that the stakeholder management and social issue participation that is observed in the year 1994 will take fairly quick effect in the market's estimation of the firm.

Merging the Stern Stewart Performance 1000 data base used for the MVA variable with the KLD data base, along with data available from Compustat for our control variables, yielded a final sample size of 308 firms. In order to make sure that this remaining sample did not differ from those firms dropped due to data availability, we tested for the difference in means for our control variables (industry, risk, and size). We found no significant differences. Testing of Hypotheses 1 and 3 was performed through correlation analysis and Hypotheses 2 and 4 were tested using regression analysis.

RESULTS

In order to test Hypothesis 1, we examined the correlation between MVA, as measured by the change between 1996 and 1995, and SM in 1994. As represented in Table 1, SM and MVA are significantly and positively correlated (0.244, $p < 0.01$). Thus, Hypothesis 1 is supported.

While a positive and significant correlation is evident between MVA and SM, Hypotheses 2 focuses on issues of causality. In order to test Hypothesis 2, we ran regression analyses with MVA (change between 1995 and 1996) as our dependent variable, SM for 1994 as our explanatory independent variable, and control variables of beta, net income, sales, and industry from 1994. Table 2 presents the results of this analysis. The overall model is significant ($p < 0.01$) with an adjusted R^2 of 0.414 and SM is positively and significantly associated with improved MVA ($p < 0.01$). Table 2 also shows that the control variables representing size (net income and sales) are significant, but risk and industry are not.¹

¹ While it is surprising that risk is not significant in our model, the finding is greatly influenced by the appearance of net income in the model. Without net income in the model,

Thus, Hypothesis 2 stating that effective stakeholder management leads to improved financial performance is supported. In order to ensure that our results were not the result of a 1-year anomaly, we also checked our analysis with a 3-year lag and found no significant differences from this model.

Hypothesis 3 posited that social issue participation would be negatively related to shareholder value creation. Table 1 presents the results of this test. As hypothesized, social issue participation is significantly (-0.286 , $p < 0.01$) and negatively correlated with shareholder value creation.

Hypothesis 4 contends that social issue participation will lead to decreased shareholder value creation. This hypothesis was tested using SIP measures for 1994 as our independent variable, along with the control variables, and MVA change 1995–96 as our dependent variable. Table 3 presents the results of this analysis. As expected, SIP has a negative relationship to the creation of shareholder value and is significant ($p < 0.05$). Thus, Hypothesis 4 also receives support in our analysis.

Additional analyses

As noted in the introduction, broader investigations of the relationship between corporate social performance and financial performance have found a recursive relationship (Waddock and Graves, 1997a). In order to evaluate the reverse order causality, that financial performance leads to stakeholder management and social issue participation, we did additional analyses using the change in MVA between 1993 and 1994 as our independent variable and SM and SIP from 1994 as our individual dependent variables. The model predicting SM was not significant ($p = 0.134$), indicating that the reverse causality is not supported. Using SIP as our dependent variable yielded a significant model, but the only predictor variable of significance was the control variable of net income with a negative effect. MVA was not significant, again indicating that the reverse causality is not supported.

Additionally, although we believe that MVA is the most appropriate operationalization of shareholder value creation, many studies of

the relationship between risk and return is as expected in a typical two-parameter model.

Table 1. Correlations and descriptive statistics

	S.D.	MEAN	MBASS	MVA	ROA	ROE	SALES	NET	SIC	BETA	SIP	SM
MBASS	462.245	39.402	1.000									
MVA	4913.883	2212.939	-0.033	1.000								
ROA	0.055	0.064	-0.095	0.165**	1.000							
ROE	0.170	0.152	-0.066	0.161*	0.708**	1.000						
SALES	18518.398	10124.786	-0.030	0.404**	-0.089	0.060	1.000					
NET	1049.636	523.056	-0.037	0.623**	0.268**	0.352**	0.779**	1.000				
SIC	14.914	37.397	0.052	-0.101	-0.140*	-0.232**	-0.028	-0.133*	1.000			
BETA	0.371	1.068	-0.190**	0.044	0.048	-0.036	-0.090	-0.015	-0.003	1.000		
SIP	1.948	-1.016	0.090	-0.286**	0.086	-0.006	-0.319**	-0.299**	0.019	0.055	1.000	
SM	2.005	0.842	-0.080	0.244**	0.101	0.105	0.160*	0.189**	-0.013	-0.028	-0.154*	1.000

* $p < 0.05$; ** $p < 0.01$

MBASS = Market-to-Book Assets; MVA = Market Value Added; ROA = Return on Assets; ROE = Return on Equity; SALES = Net Sales (proxy for size); NET = Net Income (proxy for size); SIC = Industry; BETA = Risk; SIP = Social Issue Participation; SM = Stakeholder Management

Table 2. Regression results for market value-added (MVA 95–96): stakeholder management independent variable

Variables	
SM 94	0.128** (124.397)
Sales 94	-0.202* (0.021)
Net Income 94	0.758** (0.376)
Industry 94	-0.007 (16.567)
Risk 94	0.041 (660.363)
Intercept	146.757 (990.972)
<i>R</i> ²	0.426
Adjusted <i>R</i> ²	0.414
<i>F</i>	35.132**

Standardized regression coefficients are shown; standard errors are in parentheses

N = 308

p* < 0.05; *p* < 0.01

Table 3. Regression results for market value-added (MVA 95–96): social issue participation independent variable

Variables	
SIP 94	-0.127* (132.538)
Sales 94	-0.215** (0.21)
Net income 94	0.762** (0.376)
Industry 94	-0.005 (16.589)
Risk 94	0.043 (661.510)
Intercept	104.044 (994.786)
<i>R</i> ²	0.424
Adjusted <i>R</i> ²	0.412
<i>F</i>	34.904**

Standardized regression coefficients are shown; standard errors are in parentheses

N = 308

p* < 0.05; *p* < 0.01

corporate social performance and financial performance in the past have used more traditional accounting-based measures. In order to frame this study in the context of the existing literature and to test for the sensitivity of our results to performance measure, we also ran our analyses using three additional variables often used to measure financial performance: Return on Assets (ROA), Return on Equity (ROE), and the ratio of Market to Book Assets (often called the *Q* ratio as it approximates Tobin's *Q*). Table 1 also indicates the descriptive statistics and correlation of these additional dependent variables to our predictor variables. Regression analyses in all

three cases yielded no significant results for our two variables of interest: SM and SIP. Thus, the findings using these more accounting-based measures of firm financial performance are not consistent with those using MVA.

Finally, there has been some precedent set in the literature for examining the individual dimensions of KLD as they pertain to CSP. Given this, we also conducted our analysis with MVA as our dependent variable using the five dimensions of our stakeholder management (SM) variable entered individually as presented in Table 4. Results of this analysis indicate that the dimension of community relations is the primary driver of the relationship between MVA and shareholder value creation.

DISCUSSION

We have argued that a more fine-grained approach to studying the relationship between corporate social performance and financial performance is important because of differences underlying two dimensions of CSP: stakeholder management and social issue participation. Our results using MVA as a measure of shareholder wealth creation indicate a positive relationship with stakeholder management and a negative relationship with social issue participation. Our

Table 4. Regression results for market value-added (MVA 95–96): five individual categories of stakeholder management independent variables

Variables	
PRD (Product)	-0.074 (351.574)
ENV (Environment)	-0.046 (293.524)
ER (Employee relations)	0.019 (276.568)
DIV (Diversity)	0.046 (305.401)
COM (Community)	0.225** (378.267)
Sales 94	-0.196* (0.021)
Net Income 94	0.689** (0.373)
Industry 94	0.012 (16.265)
Risk 94	0.056 (643.943)
Intercept	-800.273 (1007.584)
<i>R</i> ²	0.474
Adjusted <i>R</i> ²	0.454
<i>F</i>	23.359**

Standardized regression coefficients are shown; standard errors are in parentheses

N = 308

p* < 0.05; *p* < 0.01

results also indicate that the direction of causality is from stakeholder management/social issue participation to shareholder wealth creation/destruction. Additional analyses support this directional causality in that the reverse causality is not statistically supported. Thus, our findings are consistent with our theoretically based predictions that stakeholder management can lead to shareholder wealth creation and that participation in social issues does not lead to shareholder wealth creation.

Our results, however, should be interpreted with caution. Additional analyses using alternative measures of financial performance, ROA, ROE and Market-to-Book Assets, are not significant. As discussed in the Methods section, we strongly believe that this is a result of the problems associated with these operationalizations, rather than an indication of lack of robustness of our findings. Conceptually, MVA is the closest operationalization available to us to capture our dependent variable of interest: shareholder wealth creation. However, this is an area for future research.

Finally, while our fundamental argument is that CSP is multidimensional and that disaggregation is necessary to better understand the relationships studied herein, our additional analysis also indicates promise in disaggregating stakeholder management even further into individual components. Unfortunately, while the KLD data are the best available to researchers studying corporate social performance, these data have unique issues in their construction and aggregation that cannot be disentangled here. For example, while community relations is the only positive and significant effect found in our regression analyses, employee relations and diversity issues are also significantly correlated with MVA. Interestingly, product issues and environmental issues have an insignificant but negative relationship. This may be a result of the actual composition of the dimensions tracked by KLD. The Appendix shows that the dimensions of community relations and diversity issues track more 'areas of strength' than 'areas of concern.' The other three dimensions have a more equal balance between strengths and weaknesses. How the individual items within each category are summed to form a score for each category is undisclosed by KLD. In addition, a frequency analysis of the individual dimensions indicates that only 1.2 percent of the firms in our

sample scored negatively for the dimension of Community Relations, where firms with negative scores capture 16.9 percent of Diversity Issues, 20.9 percent of Product Issues, 21.7 percent of Employee Relations and 29.1 percent of Environmental Issues. This skewness may also have an effect on our results. Therefore, we have reason to believe that the findings in our additional disaggregation may be a result of the data rather than an indication that only one dimension of stakeholder management is positively related to shareholder wealth creation. These analyses, however, also indicate promise for further research in this area.

IMPLICATIONS AND CONCLUSION

Business firms face an increasingly competitive environment. The development of a world market for investment capital, in particular, increases the importance of competing for investment capital. Such increased competition, we believe, encourages firms to search for sources of organizational advantage that cannot be easily or quickly duplicated in order to continue to attract investment capital. Sustainable organizational advantage may be built with tacit assets that derive from developing relationships with key stakeholders: customers, employees, suppliers and communities where businesses operate.

Implications of our research are that investing in stakeholder management may be complementary to shareholder value creation and may indeed provide a basis for competitive advantage as important resources and capabilities may be created that differentiate a firm from competitors. On the other hand, participating in social issues may be seen at best as a transactional investment easily copied by competitors.

We think these findings help shed light on the dilemma faced by managers when called upon to serve an expanded role in society. Our findings suggest that if the activity is directly tied to primary stakeholders, then investments may benefit not only stakeholders but also result in increased shareholder wealth. Participating in social issues beyond the direct stakeholders, however, may adversely affect a firm's ability to create shareholder wealth.

We are not making the normative assertion that firms should not engage in such activities.

Indeed, many firms have multidimensional performance goals that may include social issue activism. However, the conflict between these goals and shareholder wealth creation should be recognized. The use of a firm's resources always has an opportunity cost. Implementing a social issue participation strategy appears to come at the cost of forgone opportunities to increase shareholder value.

Moran and Ghoshal argue for a reorientation of business strategy 'to reflect the fact that what is good for society does not necessarily have to be bad for the firm, and what is good for the firm does not necessarily have to come at a cost to society' (Moran and Ghoshal, 1996: 45). Consistent with this view, the emphasis on shareholder value creation today should not be construed as coming at the expense of the interests of other primary stakeholders. Participation by firms in all the social issues that beckon, on the other hand, may not lead to the same competitive value creation prospects as stakeholder management.

In addition, our findings may provide insight into the pattern of relationship between social performance and financial performance in past literature. Evidence here suggests the two dimensions of corporate social performance—stakeholder management and social issue participation—have opposing relationships to financial performance. This may partially explain why aggregating the two together into a measure of corporate social performance may lead to ambiguous results. Furthermore, as noted in our Methods section, our operationalization of financial performance using market value added may be an improvement over accounting measures of return in understanding the effect of intangible assets such as stakeholder relationships. This suggests that future research may extend the decoupling of social performance and further explore the differences between the dimensions as well as reconsidering measures of financial performance.

These findings create other opportunities for further research. First and foremost are the methodological issues discussed in our Discussion section. Further research focusing on alternative measures of performance and further disaggregation of our constructs is promising. In addition, the processes by which stakeholder relations are managed and the balancing of diverse demands of stakeholder groups is a ripe area for further

inquiry. Understanding how stakeholder demands may differ and how managers prioritize each would be a valuable area of future research. Are resources devoted to stakeholder relations subject to diminishing returns? If so, questions about marginal returns and optimal levels of investment should be addressed. In addition, the motivation behind social issue participation and the effects of such on the organization beyond shareholder wealth represents a gap in our understanding of social issues. We hope these results will spur further research on these and other related issues.

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APPENDIX: KLD MEASUREMENT SCREENS

Items used for stakeholder management (SM):

Community relations. *Areas of concern.* Fines or civil penalties paid, or involvement in major litigation or controversies, relating to a community in which it operates; the company's relations with a community in which it operates have become strained due to a recent plant closing or general breach of agreements with the community.

Areas of strength. The company in recent years has consistently given over 1.5 percent of pretax earnings to charity or otherwise demonstrated generous giving; the company is known for innovative giving, such as support of nonprofit agencies promoting self-sufficiency among the economically disadvantaged; the company supports education through a long-term commitment to improve programs at the primary or secondary level, or the company is a prominent recent supporter of job training programs; prominent participation in public/private initiatives that support housing initiatives for the economically disadvantaged.

Employee relations. *Areas of concern.* The company has poor relations with its unions relative to others in its industry; the company has had recent lay-offs of more than 15 percent of employees in 1 year or 25 percent of employees in 2 years; the company has paid significant fines or penalties over employee safety or been involved in major safety controversies; the company has a substantially underfunded pension plan or an inadequate benefits plan.

Areas of strength. The company has strong union relations relative to others in its industry; the company has maintained a long-term policy of company-wide cash profit sharing; the company has a substantial sense of worker involvement/ownership, sharing of financial information with employees, or employee participation in management decision making; the company

offers its employees strong retirement benefits, or other innovative benefits, relative to others in its industry.

Diversity issues. *Areas of concern.* The company has paid substantial fines or penalties or been involved in major controversies related to its affirmative action record.

Areas of strength. The company's CEO is a woman or member of a minority group; the company has made notable progress in the promotion of women and minorities, particularly to line positions; women and/or minorities hold board seats in the company; the company has outstanding benefit programs addressing work/family concerns; the company has a strong and consistent record of support for women- and minority-owned businesses (purchasing from or investing in); the company has taken innovative hiring initiatives or other human resource programs directed at employment of the disabled.

Product issues. *Areas of concern.* The company faces major recent product safety controversies; the company faces a major marketing controversy or has paid fines or penalties related to advertising practices, consumer fraud, or government contracting practices.

Areas of strength. The company has a long-standing company-wide quality program judged to be among the best in the industry; the company is an industry leader in research and development, as evidenced by expenditure as a percentage of sales, effective new product development, or unusual inventiveness; part of the company's basic mission is provision of products or services for the economically disadvantaged.

Environment issues. *Areas of concern.* The company's liabilities for hazardous waste sites exceed \$30 million or the company has significant involvement in more than 30 federal Superfund sites; the company has recently paid significant fines or penalties, has a pattern of regulatory problems or has been involved in major controversies involving environmental degradation; the company's emissions are among the highest legal

emissions of toxic chemicals in the United States; the company is among the top producers of ozone-depleting chemicals; the company's legal emissions of toxic chemicals into the air and water are among the highest of the companies followed by KLD; the company is one of the largest producers of agricultural chemicals.

Areas of strength. The company has policies to reduce emissions through elimination of toxic chemicals; the company is a substantial user of recycled materials; the company's environmentally sensitive property, plant, and equipment is among the most superior environmentally; the company derives substantial revenues from developing, using, or marketing fuels with environmental advantages, or has undertaken notable energy conservation projects; the company derives substantial revenues from alternative fuels including natural gas, wind power, and solar energy.

Items used for social issue participation (SIP)

Non-U.S. Issues. *Areas of concern.* Operations in Burma; operations in Mexico are controversial especially related to employees or the environment.

Areas of strength. The company has established a substantial, innovative charitable giving program outside of the United States.

Other. *Areas of concern.* Notably high levels of compensation to top management or board, company is involved in tax disputes, the company owns a substantial portion of a company with social concerns.

Areas of strength. Company has notably low compensation for top management or board, company owns a substantial part of a company with social strengths.

Exclusionary screens.

Alcohol/tobacco/gambling.

Military weapons contracting or supplies to Department of Defense.

Nuclear power electrical utility, designs or constructs nuclear energy plants or uranium.