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A BEHAVIORAL VIEW ON FIRM RESPONSE TO RATINGS: HOW POSITIVE  
RECOGNITION LEADS TO REDUCTIONS IN CHARITABLE CONTRIBUTIONS

A Dissertation

Presented to the Faculty of the Graduate School

of Cornell University

in Partial Fulfillment of the Requirements for the Degree of

Doctor of Philosophy

by

Ben William Lewis

January 2014

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A BEHAVIORAL VIEW ON FIRM RESPONSE TO RATINGS: HOW POSITIVE  
RECOGNITION LEADS TO REDUCTIONS IN CHARITABLE CONTRIBUTIONS

Ben William Lewis, Ph.D.

Cornell University 2014

While many rating systems incentivize firms to improve their performance, I investigate how positive recognition from external stakeholders can lead to reductions in performance, rather than improvements. Drawing upon behavioral and performance feedback theory, I argue that positive ratings can lead firms to decrease their subsequent performance by reducing uncertainty regarding standards of acceptable or appropriate conduct. Assuming that firms will seek to avoid uncertainty, I propose that such ratings can lead high-performing firms to redefine their aspirations and thus reduce their subsequent performance. I test this main hypothesis, as well as several moderating effects, by examining how firms responded to a rating that evaluated their prior philanthropic efforts. My findings suggest that firms recognized for their generosity were, under certain conditions, more likely to subsequently reduce their philanthropic contributions. From a practical perspective, these results highlight the unintended consequences of social ratings and provide further insight for policy makers and stakeholders interested in motivating improvements in corporate social performance.

## BIOGRAPHICAL SKETCH

Ben Lewis was born in Houston, Texas, and raised in Gilbert, Arizona. He received his Bachelor of Science in Accounting and Economics and Master of Accountancy from Brigham Young University in 2008. Prior to pursuing a PhD, Ben served as a volunteer for his church in Brazil and was involved in international development work in Kenya and Mozambique. Many of his research interests have been shaped by these experiences and drive his endeavors to understand how business can be used as a force for good in society. Ben began his doctoral studies at Cornell in 2008, graduating with a PhD in Management in 2014. He recently accepted a position at Brigham Young University as an Assistant Professor of Strategy in the Marriott School of Management. Ben is married to the former Paige Christensen and is the father of an 11-month old son named William.

To Paige and William

## ACKNOWLEDGMENTS

Below the search bar on the Google Scholar homepage, a website that I visit almost daily, is the iconic phrase “Stand on the shoulders of giants,” a motto that signifies the idea that one’s intellectual pursuits are built and shaped by notable thinkers of the past. In accordance with this motto, I would like to acknowledge the “intellectual giants” in my life to whom I owe my gratitude and deep appreciation.

My greatest scholarly debts lie with my committee members, Glen Dowell, Wes Sine, and Pam Tolbert. While Glen once mentioned that I took a risk becoming the student of an untenured assistant professor, I would like to think that he perhaps took the greater risk in agreeing to mentor an overly stubborn, ideologically driven, pie-in-the-sky graduate student such as myself. Indeed, I am extremely grateful to Glen for giving me space and independence to pursue my research interests in addition to providing the much-needed guidance and advice along the lengthy and sometimes arduous intellectual journey we call a PhD. I would also like to thank Wes for his support, in particular for his practical advice on how to succeed in an academic career and for encouraging me to take risks and set seemingly unrealistic expectations for myself. Pam was also a tremendous mentor whom I could always count on for prompt feedback and a positive attitude. I would do well in my career if I could somehow meet their standards of excellence in scholarship and professional development.

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## CHAPTER 1: INTRODUCTION

Carrots and sticks can achieve precisely the *opposite* of their intended aims. Mechanisms designed to increase motivation can dampen it. Tactics aimed at boosting creativity can reduce it. Programs to promote good deeds can make them disappear. (Pink, 2009, p. 35)

On April 30<sup>th</sup>, 1991, Bryant Gumbel, co-host of NBC's today show interviewed Amy Domini, co-founder of the well-known social ratings agency, KLD Research & Analytics, Inc (KLD). Founded in 1988, KLD's primary objective was to provide information to socially-minded investors that would help them identify which companies were behaving in a more or less responsible manner. As stated on their website, KLD described its mission as "providing management tools to professionals integrating environmental, social, and governance factors (ESG) into their investment decisions" (Chatterji & Toffel, 2010).

During the interview with Gumbel, however, Domini revealed another, perhaps implicit, motive of the company. When asked about KLD's long-term goals and objectives, she stated the following: "Our interest is *to increase corporate accountability* [emphasis added]. The goal here is to have *a long-term impact*. I think that's the big shift in social investing. Historically it was sin avoidance and now it's *another voice for social change*" (Gumbel, 1991).

Although KLD was one of the first organizations to issue social ratings as a way of motivating improvements in corporate behavior, it is by no means the only one. The well-known *100 Best Corporate Citizens* list, for example, has, since the year 2000, been published annually with the explicit objective of "pushing the envelope on what represents good corporate citizenship" and "moving corporations towards better practices" (Waddock, Graves, & Kelly, 2000). Today, over 100 similar types of social rating and ranking institutions exist, 80 percent of which were founded in the last ten years (Sadowski, Whitaker, & Buckingham, 2010). Although not all of these

institutions intend to directly transform corporate behavior or to hold corporations more accountable (Espeland & Sauder, 2007), many do see their ratings as a particularly effective way to drive companies and society towards a more sustainable future (Sadowski et al., 2010).

Underlying such ideologically-driven efforts is an implicit assumption that corporate behavior can be shaped through the use of rewards and punishments. Based on the theoretical foundations of behaviorism (Skinner, 1953) and standard economic theory, this “carrot” and “sticks” approach to motivation assumes that “the way to improve performance, increase productivity, and encourage excellence is to reward the good and punish the bad” (Pink, 2009, p. 19). Widely adopted and institutionalized within our homes, schools, and organizations as means of modifying and motivating improvements in *individual* behavior and performance, systems of reward and punishment are likewise seen as an increasingly effective tool to influence and control *organizational* behavior. Fombrun (1996), for example, noted that positive ratings are often given to organizations with the expressed hope that such recognition would spur imitation by poorly performing firms. Graham (2000, p. 36), likewise recognized shaming as “a newly potent political force” in shaping corporate behavior.

The dramatic increase in the establishment and implementation of rating systems like KLD’s, while perhaps an indication of progress and success, has also spurred questions about whether recognition or shame actually lead to improvements in behavior and performance. Yet while the effectiveness of rewards and punishments has been studied extensively at the individual level, only recently have organizational scholars sought to examine how *organizations* respond to such incentives and whether and when they influence subsequent firm behavior and performance (Chatterji & Toffel, 2010; Jin & Leslie, 2003; Schlenker & Scorse, 2012).<sup>1</sup> A common finding

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<sup>1</sup> By performance, I mean the dimension of performance that corresponds to the particular social rating.

among the extant literature is that organizations that receive negative ratings tend to improve. The majority of this research, however, has not sufficiently addressed whether ratings that recognize an organization's positive qualities and characteristics might similarly influence organizational behavior and performance.

Given these insights, the goal of the dissertation is to investigate the following two questions. First, how do organizations respond to positive recognition? And second, under what conditions do they respond, i.e. when do they respond? In exploring these questions, I take a behavioral perspective (Cyert & March, 1963; March & Simon, 1958) and draw upon additional insights from psychology and economics to theorize how positive recognition might influence subsequent organizational performance. A central idea of the behavioral perspective is that organizational decision makers (i.e. managers) use aspiration levels when evaluating their organizations' performance (Greve, 2003b). While prior research suggests that aspiration levels are formed based on the firm's own performance history as well as the performance of similar others (Cyert & March, 1963), in this study, I argue that positive ratings can directly alter organizational aspirations by redefining the standards of appropriate and acceptable behavior. Assuming the firms will seek to avoid uncertainty and create negotiated environment (Argote & Greve, 2007; Cyert & March, 1963; DiMaggio & Powell, 1983), such ratings could lead high-performing firms that meet or exceed the newly defined standard to redefine their aspirations and thus reduce their subsequent performance. Thus, contrary to conventional wisdom, my primary hypothesis is that positive ratings will lead to performance reductions rather than improvements.

---

For example, the performance effects of an environmental rating could include subsequent changes in the release of toxic emissions (Chatterji & Toffel, 2010; Doshi, Dowell, & Toffel, 2013).

While organizations can receive positive recognition in a variety of ways, in this study, I specifically focus on how firms respond to social ratings that recognize and reward firms for their generosity. My primary argument is that efforts to motivate high levels of corporate giving through the use of positive recognition can, under certain conditions, lead high-performing firms to reduce their subsequent contributions. I call this idea the paradox of recognizing responsibility. I test this hypothesis using ratings data from KLD, the oldest and most widely used social ratings database available to the public (Chatterji, Levine, & Toffel, 2009; Chen & Delmas, 2011). Using a difference-in-differences methodology, I examine how hundreds of organizations responded to their initial ratings when KLD first began rating firms in 1991.

In this study, I make several important theoretical and practical contributions. My first contribution is a redefinition of our understanding about how organizations respond to positive recognition. Indeed, the notion that positive recognition can lead to unintended consequences is not new. Psychologists, for example, have long recognized that efforts to motivate improvements in individual behavior and performance through positive recognition can often lead to outcomes that are “precisely the opposite of their intended aims” (Pink, 2009, p. 35). Despite this knowledge however, many rating institutions and stakeholders continue to operate under the untested assumption that the use of positive recognition as a reward is indeed an effective way to drive improvements in *organizational* behavior and performance. In this study, I question that assumption and subject it to rigorous empirical scrutiny. Drawing upon insights from social psychology, economics, and organization theory, I seek to not only provide a more nuanced understanding about how organizations respond to positive recognition, but also explain why and when it



might be more or less effective in shaping and modifying *organizational* behavior and performance.

I also seek to extend performance feedback theory by examining how third-party ratings can alter a firm's aspiration level, a previously stated, yet unexplored assertion (Greve, 2003b). While behavioral scholars have long recognized the role of historical performance and social comparison in the formation of organizational aspirations, in this study, I argue and demonstrate how positive ratings can redefine organizational goals that can lead recognized firms to reduce their subsequent performance.

From a practical perspective, this study thus highlights the unintended consequences of social ratings (Chatterji & Levine, 2006) and provides stakeholders interested in motivating improvements in corporate responsibility with valuable information about how independent rating systems can be designed in ways that promote societal benefit (Lydenberg, 2005; Margolis & Walsh, 2003).

This dissertation is organized as follows. In chapter 2, I provide an in-depth review of the relevant literature, drawing specifically on insights and topics from psychology and economics. Following this review, I provide my own summary of the literature highlighting both the general conclusions that can be drawn from numerous studies as well as the gaps in our understanding that need to be filled. More specifically, I emphasize the importance of understanding how firms respond to positive recognition and introduce a setting in which this question can be adequately addressed.

In chapter 3, I introduce the context of the empirical analysis by providing a brief history of socially responsible investing and the institutionalization of corporate social ratings. I then provide a detailed description of the KLD ratings, the primary data source for my empirical analysis. I conclude by performing a thorough review of

articles using the KLD data in order to highlight our limited understanding about how firms response to positive recognition.

Chapters 4 and 5 contain my hypotheses and empirical results respectively. Beyond my main argument, I also examine several contingency factors that may moderate a firm's response to the positive rating. Specifically, I hypothesize and examine how firm response to positive recognition will be moderated by several institutional and organizational factors.

I discuss my findings and conclusions in Chapter 6. In this section, I outline my primary theoretical contributions, note the study's limitations, and highlight areas for future research. I conclude with a general discussion about the policy implications of my research, focusing specifically on how social rating systems might be redesigned to maximize societal benefit.

## **CHAPTER 2: INDIVIDUAL AND ORGANIZATIONAL RESPONSES TO REWARDS AND PUNISHMENTS**

Research regarding the effects of rewards and punishments has deep historical roots, particularly with the disciplines of psychology and economics. Because an exhaustive review of these disciplines in relation to this topic would be beyond the scope of this study, in this chapter, I intend to highlight the important findings, concepts, and insights that scholars have accumulated over the years that could potentially inform our understanding about how organizations might respond to positive recognition. Given that these disciplines have evolved on somewhat separate paths, I review them separately.

I first review the literature within the field of psychology. I begin by summarizing the basic tenets of behaviorism and their manifestations in society. Highlighting the work of Edward Deci and other influential psychologists and behavioral economists, I then seek to demonstrate that many of the foundational assumptions of behaviorism and the conventional wisdom of society regarding the efficacy of rewards as a tool to influence and control behavior and performance are indeed false and unsupported by scientific record. I then make the argument that the unintended consequences of rewards and punishments at the individual level suggest that similar effects may occur at the organizational level.

I then turn to the economic literature. Like behaviorism, neoclassical economic theory shares a similar belief that economic actors, both individuals and organizations respond to both punishments and rewards (i.e. incentives). Yet while much of this research has found broad support for the efficacy of punishment as a motivational tactic, few studies have addressed the efficacy of rewards and positive recognition.

To address this gap, I thus propose to examine how organizations respond to positive recognition from independent ratings agencies that evaluate and recognize past superior performance. While ratings have been used to evaluate various dimensions of organizational behavior and performance, in this study, I intend to evaluate how large public corporations respond to ratings that evaluate their social and environmental performance.

### **Individual-Level Responses to Rewards and Punishments**

Although the use of rewards and punishments as a means of controlling behavior has likely existed throughout human history, it wasn't until the early 1900s that psychologists developed a theory to actually explain and systematize their effects (Kohn, 1999). Known as behaviorism, this intellectual tradition held that individuals or other living organisms might be predisposed, or conditioned, by their environments to behave in certain ways. Of particular import was Skinner's (1953) theoretical framework of operant conditioning, a model of learning in which an organism's behavior could be controlled through reinforcement or punishment. Using rats and pigeons as experimental subjects, Skinner and his colleagues ran hundreds of experiments and found broad support for the idea that behavior could be controlled by the conferral or withdrawal of rewards and punishments. Summarizing these findings, Deci et al. stated,

When administered closely subsequent to a behavior, rewards were reliably found to increase the likelihood that the behavior would be emitted again, an effect that persisted as long as the reward contingency was operative. When rewards were terminated, the likelihood that the behavior would be emitted eventually returned to the prereward baseline. (1999, p. 627)

Although simple and perhaps intuitive, the consistency of this general finding led to the widespread advocacy of rewards as motivational strategy, particularly within the applied fields of business and education.

Yet while behaviorism became the dominant school of thought during the 1950s, it did not escape criticism. Maslow (1954), for example, questioned the idea the human behavior could be simply reduced to rat-like responses to positive and negative stimuli. McGregor (1960) likewise doubted behaviorism's strong assumption that absent external rewards and punishments, humans beings were essentially inert. Responding to these concerns, psychologists interested in the study of human motivation began to reexamine the fundamental assumptions of the behaviorist tradition.

The first empirical research to question this tradition emerged in the early 1970s. At that time, Edward Deci, a graduate student at Carnegie Mellon, was interested in understanding how rewards influenced intrinsic motivation, that is, "the desire to engage in an activity for its own sake" (Kohn, 1999, p. 290). Through a series of experiments, Deci (1971, 1972) found that contrary to conventional wisdom, tangible rewards (i.e. money) could significantly *reduce* an individuals' intrinsic motivation in an activity, thus leading him to the seemingly controversial conclusion that "one who is interested in developing and enhancing intrinsic motivation in children, employees, students, etc., should not concentrate on external-control systems such as monetary rewards" (Deci, 1972, pp. 119–120).

Since that time, hundreds of studies have sought to replicate these results and further refine our understanding about how rewards influence motivation. With surprising consistency, these studies strongly support the conclusion that "tangible rewards tend to have a substantially negative effect on intrinsic motivation" (Deci et al., 1999).

Beyond reducing intrinsic motivation, rewards have also been shown to both diminish and amplify desirable and undesirable outcomes or behaviors respectively. Psychologists (and more recently behavioral economists), for example, have found extrinsic rewards to lead to reductions in performance (Ariely, Gneezy, Loewenstein, & Mazar, 2009; Glucksberg, 1962; Miller & Estes, 1961), creativity (Amabile, 1985, 1996; Amabile, Hennessey, & Grossman, 1986; Amabile, Phillips, & Collins, 1993), and prosocial behavior (Ariely, Bracha, & Meier, 2009; Mellström & Johannesson, 2008). On the flipside, recent research suggest that rewards may increase the likelihood of undesirable outcomes such as cheating and dishonesty (Ordóñez, Schweitzer, Galinsky, & Bazerman, 2009), addictive behaviors (Knutson, Adams, Fong, & Hommer, 2001; Kuhnen & Knutson, 2005), and myopic decision-making (Cheng, Subramanyam, & Zhang, 2005; Ordóñez et al., 2009). As noted by Pink, these studies succinctly demonstrate that “carrots and sticks can achieve precisely the opposite of their intended aims. Mechanisms designed to increase motivation can dampen it. Tactics aimed at boosting creativity can reduce it. Programs to promote good deeds can make them disappear” (2009, p. 35).

Indeed, forty years of work within the field of psychology has clearly demonstrated the unintended consequences of using extrinsic rewards as a tool to motivate improvements in behavior and performance.<sup>2</sup> Despite this knowledge, however, much of our society continues to operate under the taken-for-granted assumption that the most effective way to “improve performance, increase productivity, and encourage excellence is to reward the good and punish the bad”

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<sup>2</sup> Although the negative effects of rewards are well documented, social scientists have demonstrated a small number of circumstances under which they are effective. For instance, scholars have shown that the negative effects of rewards on intrinsic motivation primarily occur with contingent rewards (i.e. rewards promised upon completion of a task or behavior) (Lepper, Greene, & Nisbett, 1973). Rewards can also lead to increased performance, but only for mindless tasks that require little cognitive skill (Ariely, Gneezy, et al., 2009; Deci, Koestner, & Ryan, 2001).

(Pink, 2009, p. 19). Such an assumption permeates almost every aspect of our society including our schools, our organizations, and our homes. Teachers, for example, present “stickers, stars, certificates, awards, trophies, membership in elite societies, and above all, grades” to entice students to learn (Kohn, 1999, p. 11). From Wall Street to Main Street, boards and managers offer extravagant bonuses or special perks to CEOs and employees, all motivated by the simple idea that “the more money you offer someone, the harder he or she will work” (Francella, 1983, p. 53). Even at home, parents promise children special privileges for good behavior, extra dessert for eating their vegetables, or allowance when completing household chores. Indeed, systems of rewards and punishments are “so deeply embedded in our lives that most of us scarcely recognize that they exist” (Pink, 2009, p. 19).

Beyond their intent of motivating individual behavior and performance, systems of rewards and punishments are likewise seen as an increasingly effective way to motivate improvements in organizational behavior and performance. Yet despite our vast understanding about how individuals respond to tangible and verbal rewards, we actually know very little about how organizations respond to these same motivational tools. Although there are indeed inherent conceptual differences between individuals and organizations,<sup>3</sup> the consistency of the findings within psychology in regards to the negative effect of rewards suggest that similar negative effects may occur at the organizational level. In accordance with this assertion, I now turn to the economic literature to review our current understanding about how organizations respond to rewards and recognition.

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<sup>3</sup> One would not necessarily expect rewards and punishments to drive changes in behavior and performance through the same theoretical mechanisms at the organizational level. It would be difficult, for example, to argue that corporations haven an “intrinsic motivation” to engage in certain activities or behaviors as most corporations, by legal status, are organized with the primary objective of maximizing profits.

## **Organizational-Level Responses to Rewards and Punishments**

The idea that rewards and punishments can be used to motivate improvements in organizational behavior and performance is strongly rooted in rational choice paradigm of modern economic theory (Benabou & Tirole, 2003; Lazear, 2000). According to this theoretical framework, organizations or firms are assumed to be rational actors that respond to various incentives in order to maximize their profits. While such incentives continuously evolve through the market dynamics of supply and demand, they can also be manipulated by external actors or stakeholders who have an interest in ensuring that organizations act in accordance with the public good. These external stakeholders include both the government as well as private groups of concerned citizens. I therefore briefly review the literature on organizational response to government and other external stakeholders, also referred to as public and private politics respectively (Baron, 2003; Reid & Toffel, 2009), paying particular attention to the tools or tactics used, the mechanisms through which these tools and tactics influence behavior, and their effectiveness in motivating improvements in performance.

### **Public Politics**

Since the rise of the modern bureaucratic organization (Weber, 1968), government regulators have utilized a variety of regulatory strategies to ensure that public and private organizations comply with the law and to motivate improvements in behavior and performance. While much of the early history of government regulation had been dominated by more direct regulatory approaches such as command-and-control strategies and voluntary compliance programs, recent decades have seen a shift towards more cost-effective strategies such as market-based incentives, and mandatory information disclosure (Fung, Graham, & Weil, 2007).



*Command-and-Control.* Command-and-control can be described as a centralized regulatory approach that relies on legislation, inspections, and sanctions to monitor and control the activities of organizations (Jennings & Zandbergen, 1995; Nash & Ehrenfeld, 1997). Such legislation usually takes the form of (1) performance-based standards that specify certain performance expectations or goals or (2) technology-based standards that mandate the use of certain technologies or designs (Kleindorfer & Orts, 1998; Nash & Ehrenfeld, 1997). Underlying this approach is the assumption that organizations are “amoral calculators” (Kagan & Scholz, 1984), and will therefore only undertake costly measures to comply with public policy goals when specifically required to do so by law and when the cost on noncompliance is likely to be detected and harshly penalized (Becker, 1968; Gunningham, Thornton, & Kagan, 2005; Stigler, 1970).

Command-and-control regulations typically drive changes in organizational behavior and performance through direct coercion. Organizations that fail to attain certain performance goals or adopt certain practices or technologies will often face fines, fees, or other civil and/or criminal penalties that can take a significant financial toll on the organization (Fung et al., 2007). Given the substantial costs associated with noncompliance, it is therefore unsurprising that most research has found command-and-control regulations to be an effective tool in modifying and improving organizational behavior and performance (Cohen, 2000; Short & Toffel, 2008). Beyond direct coercion, threats of federal regulation have also been shown to have strong “general deterrence” effect on behavior, particular for organizations that share the same institutional field (i.e. industry or community) of the targeted organization (Reid & Toffel, 2009).

*Voluntary Programs.* While command-and-control strategies have often been considered a favored policy tool for federal regulators because of their effectiveness at

ensuring compliance, critics have noted that the establishment of minimum standards of performance tends to encourage reactive responses rather than proactive solutions (Nash & Ehrenfeld, 1997). To thus motivate organizations to make “beyond-compliance” improvements, federal regulators have also relied on voluntary programs that seek to motivate improvements in performance through rewards rather than punishments (Vogel, 2005). Organizations that join such programs generally make commitments to reach certain performance goals. Regulators, in turn, promise to provide feedback as well as public recognition for their efforts. The basic mechanism underlying these programs is the idea that public recognition will serve as a strong incentive for organizations to improve their performance, as such recognition will likely increase the organization’s reputation among consumers which can then lead to subsequent increases in demand for the organization’s goods and services.

Nevertheless, while there has been some evidence to suggest that recognition spurs improvements in behavior and performance, particularly among firms with high levels of customer interaction (Arora & Cason, 1995; Arora & Cason, 1996), concerns about self-selection and other research design issues raise questions about the causal nature of these improvements (Harrison, 1998; Kleindorfer & Orts, 1998).

*Market-Based Incentives.* Critics have also argued that command-and-control strategies tend to be economically inefficient and are unnecessarily slow and inflexible (Harrison, 1998; Nash & Ehrenfeld, 1997). To thus reduce the costs associated with direct government oversight, federal regulators have recently sought to harness the power of market forces to compel organizations to act in accordance with the public interest. Traditional market-based incentives include subsidies, taxes, or mechanisms for reassigning property rights and responsibilities (e.g., emissions trading schemes). Unlike command-and-control and voluntary programs which seek to punish and reward firms directly, market-based approaches seek to indirectly influence

organizational behavior by altering market incentives. While some market-based initiatives have substituted for traditional command-and-control regulations, in most instances they serve as complements by adding flexibility and increasing cost-effectiveness (Tietenberg, 1998).

*Mandatory Information Disclosure.* One increasingly popular form of market-based regulation is mandatory information disclosure. In contrast to traditional regulatory approaches that rely on elaborate systems of rewards and punishments, mandatory disclosure programs seek to indirectly promote and encourage changes in behavior through the power of information (Fung et al., 2007). Implicit in this approach is the assumption that consumers, investors, and other stakeholders lack full information regarding the behavior and performance of corporations and other public organizations (Akerlof, 1970). Such asymmetries in information arise because organizations know more about their products, practices, and performance than their stakeholders do (Weil, Fung, Graham, & Fagotto, 2006). By forcing companies and other public organizations to reveal previously hidden dimensions of their performance and behavior, regulators hope to alter the decision-making processes of consumers, investors, and other stakeholders in ways that create market or political pressures for organizations to modify their behavior (Fung et al., 2007)

Information disclosure can drive improvements in organizational behavior and performance through three primary channels (Benneer & Olmstead, 2008). First, new information can alter consumer and investor demand for an organization's goods or securities. Several studies, for example, have demonstrated how restaurant grade cards based on mandatory health inspections can alter consumer demand for food, thus creating strong incentives for restaurant operators to improve or maintain good hygiene (Jin & Leslie, 2003, 2009; P. A. Simon, Leslie, Grace, Jin, & et al., 2005). Research has also demonstrated that organizations with high levels of toxic emissions

are more likely to experience negative abnormal stock returns (Hamilton, 1995). Such reductions in investor demand can then encourage the dirtiest firms to significantly reduce their toxic emissions in subsequent years (Khanna, Quimio, & Bojilova, 1998; Konar & Cohen, 1997).

Newly disclosed information can also encourage action by community activists and government regulators. Several studies, for example, suggest that upon learning the true level of pollution in their community, local nonprofits and other community activists can induce dirty firms to reduce their emissions or change locations (Baron, 2001; Khanna et al., 1998). Neighborhood groups can also use the TRI data to lobby regulators and lawmakers to increase regulatory oversight (Oberholzer-Gee & Mitsunari, 2006). Even threats of stringent regulation might provide sufficient incentives to improve performance (Maxwell, Lyon, & Hackett, 2000).

Finally, information disclosure can also spark internal improvements in performance. Environmental audits, for example, help managers learn about current inefficiencies and opportunities for improvement (Blackman, Afsah, & Ratunanda, 2004). In the case of mandatory information disclosure, the mere act of disclosing can lead managers to dispense for resources and attention towards problem issues that were previously ignored (Sharma, 2000).

A substantial body of research has demonstrated that organizations do indeed respond to the release of new information. Several studies, for example, have found the mandatory disclosure of toxic emissions to lead companies to improve their environmental performance (Doshi et al., 2013; Khanna et al., 1998; Konar & Cohen, 1997) . Similar improvements in behavior and performance have been found in the domains of food and water safety (Bennear & Olmstead, 2008; Jin & Leslie, 2003, 2009; P. A. Simon et al., 2005), healthcare (Cutler, Huckman, & Landrum, 2004; Hannan, Kilburn, Racz, Shields, & Chassin, 1994; Peterson, DeLong, Jollis,

Muhlbaier, & Mark, 1998), and mortgage lending (Bostic & Surette, 2001; Munnell, Tootell, Browne, & McEneaney, 1996; Roth, 2003; Schafer & Ladd, 1981). Overall these results provide substantial support for information disclosure as a particularly effective regulatory tool.

### **Private Politics**

While federal regulation certainly plays an important role in monitoring and motivating improvements in organizational behavior and performance, recent decades have seen a rise in “private politics” (Baron, 2001, 2003). Also referred to as civil regulation (Vogel, 2005), private politics can be conceptualized as the individual and collective efforts of private citizens, activists, social movement organizations, and other nongovernmental organizations (NGOs) to impose their will on other individuals or organizations without reliance on the law or government (Baron, 2003). By applying pressure to these organizations, these activists and social movement organizations seek to motivate changes in organizational behavior and performance that the government is either unwilling or unable to bring about (Vogel, 2005).

*Social Activism.* Social activists and other NGOs generate pressures on corporations and other public organizations through various means. Some tactics, such as protests, boycotts, and media campaigns, are driven by social activists who seek to bring about change by influencing consumer and investor demand (Bartley & Child, 2011). Boycotts, for example, are believed to be successful when they take potential revenue away from the firm, thereby putting pressure on organizations to change (King, 2008). Protests and other media campaigns can also inflict damage on organizations through “naming and shaming” (Baron, 2003; Bartley & Child, 2011; O’Rourke, 2005). Such shaming tactics are particularly effective on organizations that seek to maintain a strong reputation or brand identity (Rodríguez-Garavito, 2005;

Vogel, 2005). Shareholder activism, defined as “use of ownership position to actively influence company policy and practice” (Sjöström, 2008, p. 142), is another increasingly popular tool in private politics. Such activism often takes the form of shareholder resolutions which are proposals made by shareholders intended to influence the decisions and strategies of the top management team (Reid & Toffel, 2009).

Although not all attempts to directly influence managerial decisions are successful, there does appear to be some empirical evidence that organizations and industries will modify their behavior and subsequent performance in response to these tactics. Boycotts and protests, for example, can create public image crises for organizations, which then motivate organizations to concede to activists’ requests (Friedman, 1985; King, 2008; Pruitt & Friedman, 1986). Media campaigns established with the intent to “name and shame” have also been shown to motivate improvements in both labor conditions (Bartley & Child, 2011) and environmental performance (Schlenker & Scorse, 2012). Finally, recent research provides evidence that both targeted firms and their institutional equivalents respond to requests made by shareholder activists (Reid & Toffel, 2009), particularly when requests complement increased regulatory threat by the government. Together, this body of work provides ample evidence that social activists and other NGOs can motivate significant improvements in organizational behavior and performance (Vogel, 2005).

*Private Regulatory Systems.* Another way private politics shape organizational behavior and performance is through the creation of private regulatory institutions that define standards of appropriate behavior and performance (King & Pearce, 2010; Lenox, 2006; O’Rourke, 2003). Typically these standards originate as principles or codes of conduct that arise in response to large-scale crises (Nash & Ehrenfeld, 1997). The Ceres Principles, for example, were established to guide corporate behavior on

important environmental issues following the Exxon Valdez oil spill in 1989. Once standards are established, independent regulatory institutions then monitor performance and certify organizations that act in accordance with the standards (Bartley, 2003, 2005; O'Rourke, 2003). Because these institutions lack the authority of the state, they cannot force organizations to comply (Lenox, 2006). External endorsements, however, can increase both the legitimacy and reputation of an organization (Rao, 1994; Rindova, Williamson, Petkova, & Sever, 2005; Sine, David, & Mitsuhashi, 2007), and thus provide strong incentives for uncertified organizations to improve (King & Pearce, 2010).

Beyond setting standards, many private regulatory institutions also act as information intermediaries that rank and rate organizational behavior and performance (Bartley, 2003; Chatterji & Toffel, 2010; O'Rourke, 2005). Like mandatory disclosure, information disclosure by independent third-parties reduces the costs associated with private regulation by transferring the responsibility of monitoring and enforcement to the users of information (i.e. consumers, investors, communities, etc.) (Vogel, 2005). While some ranking and rating institutions see their primary objective as providing transparency, many also hope that the information they provide will create market or political incentives for organizations to modify their behavior (Weil et al., 2006).

Although targeted organizations are not required to respond to requests made by private regulatory systems, there exists some evidence that these organizations do indeed respond. Organizations that receive low rankings, for example, often perceive the ranking as an identity threat (Dutton, Dukerich, & Harquail, 1994; Elsbach & Kramer, 1996) and are thus motivated to improve their performance in subsequent years. Consistent with this argument, Espeland and Sauder (2007) found that law schools unsatisfied with their US News and World Report ranking altered how

resources were allocated, redefined the work of their employees, and employed a variety of gaming strategies in order to improve their rank in subsequent years. Negative ratings have also been shown to spur improvements in behavior and performance. Chatterji and Toffel (2010), for example, found that firms that initially received poor environmental ratings subsequently reduced their release of toxic emissions compared to other firms. Likewise, Schlenker and Scorse (2012) demonstrated that regulated facilities that were removed from a “Top 10” worse polluter list increased their emissions by 50 percent more than they would have had they stayed on the list.

### **Conclusions**

Two general conclusions can be derived from the literature on the performance effects of public and private politics. First, substantial support exists for the efficacy of punishment in motivating improvements in organizational behavior or performance. As noted, a number of studies have demonstrated that fines, fees, and other methods of direct coercion lead organizations to alter their practices and behaviors, albeit often at minimum level required to be in compliance with the law. Private regulatory tactics such as “naming and shaming” have also been shown to motivate improvements in behavior, particularly for organizations that view their reputation and brand as a source of competitive advantage (Barney, 1991).

Second, despite implicit beliefs in the efficacy of rewards and recognition, we have a limited understanding regarding whether these tactics actually lead to improvements in organizational behavior and performance. One of primary reasons that we know so little about how organizations respond to positive recognition may be structural in nature. As noted earlier, most public and private efforts to motivate improvements in behavior and performance through rewards or recognition rely on the



voluntary participation of organizations. While positive recognition could very well motivate improvements in behavior and performance, organizations are not randomly assigned to join such programs, but rather join by self-selection. Such self-selection factors have been known to introduce bias in empirical analysis, thus making it difficult to evaluate the true causal nature of positive recognition (Kim & Lyon, 2011).

Despite these methodological difficulties, understanding how organizations respond to rewards and recognition is important from both a theoretical and empirical perspective as many public and private initiatives are founded upon the implicit belief that organizations, like individuals, will respond favorably to rewards and positive recognition. Furthermore, noting this lack of understanding, scholars have recently called for more research to examine how organizations respond to positive recognition (Chatterji & Toffel, 2010). I seek to address this call by examining how firms respond to third-party ratings that recognize past superior performance. To overcome the problems of self-selection associated with voluntary programs, I rely on an exogenous source of variation that occurred when the ratings were first issued.

While third-party ratings have been used as means of evaluating various dimensions of performance and behavior,<sup>4</sup> in this study, I seek to understand how large public corporations responded to the introduction of ratings that evaluated their social and environmental performance. As a relatively recent phenomenon emerging over the last 25 years, the rise and proliferation of social ratings is an ideal context in which to study how organizations respond to positive recognition as it allows the researcher to examine changes in firm behavior and performance in response to the introduction of the rating. In order to provide a more enriched discussion and

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<sup>4</sup> Common examples of third-party ratings include *Consumer Reports'* ratings of consumer products, *Yelp's* ratings of restaurant quality, and *Moody's* and *Standard & Poor's* ratings of credit worthiness.

description of these ratings, I briefly review the historical context under which these social ratings first emerged.

## **CHAPTER 3: THE ORIGINS OF SOCIALLY RESPONSIBLE INVESTMENT AND THE RISE OF CORPORATE RESPONSIBILITY RATINGS**

Ratings that evaluate corporate social and environmental performance are a relatively recent phenomenon that grew out of the socially responsible investment (SRI) movement. Also known as sustainable, socially conscious, or ethical investing, SRI is an investment strategy that considers corporate responsibility and societal concerns, in addition to financial return, as valid components of investment decisions (“SRI Basics,” 2013). SRI has grown dramatically since the mid-1990s with assets under management growing from \$639 billion in 1995 to \$3.74 trillion in 2012. Today, nearly one in every nine dollars under professional management in the US is involved in sustainable and responsible investing.

Initially intended to help individuals and organizations avoid making unethical or immoral investments, many socially-oriented investment funds now serve as rating agencies (Paul & Lydenberg, 1992) that rank and evaluate corporate social performance in order to help investors to “identify which firms are more or less responsible” (Vogel, 2005, p. 39). Although most rating agencies are not explicit about their intentions to pressure companies, many believe that providing investors with information is indeed an effective way to drive improvements in corporate behavior (Lydenberg, 2005).

In the following sections, I briefly review the historical context and events that led to the emergence of socially responsible investment and the formation and institutionalization of corporate social ratings. I then discuss and describe in detail the KLD social ratings, the primary data source for my empirical analysis.

## **The Origins of Socially Responsible Investment**

The earliest origins of social investing can be traced back to the religious teachings and philosophies of early Christian churches. John Wesley, one of the founding fathers of Methodism, taught that proper use of money was the second most important subject of new testament teaching (Mackenzie, 1997). In 1744, he gave a sermon titled *The Use of Money*, which outlined the basic tenets of social investing; that fellow Christians should earn all they can, but not at the expense of conscience, or the expense of their neighbors wealth and health. The Quakers, likewise, emphasized pacifism and the “moral inconsistency of holding slaves” (Thomas, 1999, p. 460), and thus taught their members to refuse participating in war and the slave trade. Indeed, such morally-based teachings underpinned much of the investment behaviors of religious institutions and socially-minded investors through the first seventy years of the 20<sup>th</sup> century (Godfrey, 2011) and their influence can still be seen today in the widespread avoidance of “sin stocks,” or investments made in companies that engage in the production of alcohol, arms, and tobacco (Schueth, 2003).

Yet despite its early origins, SRI remained largely a fringe phenomenon until the early 1970s. At that time, themes of protest and activism arising from the Anti-Vietnam War and Civil Rights movements, and concerns about the Cold War and equality for women, began to fuel greater concerns for corporate social responsibility and accountability (Schueth, 2003). Responding to these concerns, Luther Tyson and Jack Corbett, two Methodist ministers, founded the PAX World Fund in 1971, the first socially responsible mutual fund to exclude weapons makers from their portfolio. Other funds and investment agencies soon emerged employing similar types of social investment services (Godfrey, 2011). The US Trust Company (now Walden Asset Management), for example, was founded in 1975 as the first in-house research division of a bank dedicated to social investing. In 1982, Joan Bavaria established

Franklin Research and Development Corporation, the first money management firm to focus exclusively on social investing. By the 1980s, these social investment funds managed approximately \$40 billion in assets (J. Shapiro, 1992) with the majority employing a passive investment strategy known as negative screening, or the systematic exclusion of objectionable investments (Kurtz, 2008).

While some socially-minded investors were more comfortable taking a passive stance, others desired to take a more active role in changing corporate behavior. One such individual was Saul Alinsky. Upset over labor conditions and lack of recognition and opportunities for advancement for the black community of Rochester, New York, Alinsky, a noted community organizer and social activist, purchased enough shares of Eastman Kodak stock in 1967 to gain admittance to the company's shareholder meeting. Once inside, Alinsky filed a proxy resolution demanding that the company do more for the young African American population in the community. Although the use of shareholder resolutions had been legalized by the SEC in 1942, this particular resolution was noteworthy for being the first direct demand by a shareholder for a large corporation to solve a social problem (Paul & Aquila, 1988).

Such an event was a watershed moment in the history of shareholder activism and served as a catalyst for further demonstrations of activism and corporate engagement. In 1970, a group of young lawyers formed the Project for Corporate Responsibility, and shortly thereafter presented nine resolutions to General Motors, all of which addressed social issues faced by minorities, workers, and consumers (Paul & Aquila, 1988). Wanting a more active method to voice their religious beliefs and concerns, churches followed suit and soon became the largest submitter of proxy resolutions during the 1970s (Godfrey, 2011).

Increased interest in social investing and shareholder activism also led to the formation of several new organizations. Founded in 1969, the Council of Economic

Priorities (CEP) published a variety of industry studies and reports on special topics of interest to consumers, activists, and public policy analysts (Paul & Aquila, 1988). In 1972, religious investors and other faith-based institutions founded the Interfaith Council on Corporate Responsibility (ICCR) as a way to organize their efforts into one collective voice. That same year, a group of major universities and foundations established the Investor Responsibility Research Center in Washington, DC with a similar mission of providing proxy research, analysis, and services to large institutional investors. Seeking to formalize and coordinate their efforts, early pioneers also established the Social Investment Forum, the industry's first professional association. Founded in 1985, the Forum's primary objective was to act as a facilitator, advocate, and national clearinghouse for information on social investing (Kinder, Lydenberg, & Domini, 1992). Together, these organizations served to increase awareness about social investing and establish legitimacy of the new burgeoning industry.

A number of historical events also helped transform social investing from a fringe to a mainstream phenomenon (Paul & Lydenberg, 1992). Most noteworthy was the issue of divestment from South Africa. While opposition toward South Africa's Apartheid system had been in effect since the United Nations issued Resolution 1761 in 1962 (Godfrey, 2011), several high profile protests and shareholder resolutions during the late 1970s and early 1980s led many institutional investors, such as pension plans and universities, to divest stocks of companies doing business in South Africa.<sup>5</sup> Under intense political and economic pressure, many US companies slowly began to withdraw their operations from the country.<sup>6</sup> Several unfortunate environmental

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<sup>5</sup> According to Knight (1990), over 300 educational institutions had divested from South Africa by 1988.

<sup>6</sup> Paul (1989) notes that 143 companies had left South Africa by 1987 with 65% leaving during the years of 1986 and 1987.

disasters also occurred during the 1980s, including the Bhopal, Chernobyl, and Exxon Valdez incidents, which sparked further media scrutiny and helped to bring issues of corporate responsibility and accountability into the spotlight (Schueth, 2003).

By the late 1980s, it was clear that a new industry and form of investing had emerged. The rise of socially responsible investment funds now allowed socially-minded investors to customize their portfolios according to their values and priorities. Shareholder resolutions were also viewed as a particularly effective tool in driving improvements in corporate behavior. Professional organizations and industry associations further established the industry's legitimacy and credibility within the broader investment community. Together these factors led the industry to grow from \$40 billion in assets under management in 1984 to \$825 billion by 1991 (J. Shapiro, 1992).

Along with this increased interest in social investing came a shift in strategy. No longer were investors simply interested in avoiding investments in certain companies. Having learned from their successes with proxy resolutions and the divestment from South Africa, many began to see themselves as agents of positive change. These shifts in identity and purpose led many investors to begin using "positive screens" in an effort to encourage improvements in the policies and practices of corporations. Unlike exclusionary screens, which investors used to keep their funds out of certain types of stocks, positive screens were used to identify and reward emerging companies applying progressive policies. Underlying these efforts was the belief that the "clout of the marketplace" could be harnessed to motivate low-performing firms into reforming their irresponsible practices ("After South Africa: The state of socially responsible investing in the United States," 1995).

One limitation of this proactive approach, however, was that it required much more information and research regarding corporate social practices. While demand for

socially-screened investments was indeed high, information on corporate social performance was in limited supply. Unlike the financial and accounting information that was easily accessible in annual reports and SEC filings, data on a company's environmental and social practices was often not publicly available or easily accessible and therefore costly and difficult to obtain.

### **The Rise of Corporate Responsibility Ratings**

Seeking to fill this information gap, a number of organizations began to rate and evaluate corporate social performance and publicize their research. While impactful because of their novelty, these early rating systems were limited in scope, both in terms of the number of companies and social issues evaluated. The CEP, for example, had published a series of reports in the 1970s that rated the environmental and fair hiring practices of US corporations (Paul & Lydenberg, 1992). Although extremely informative, these reports tended to focus on single industries or specific issues which limited an investor's ability to determine which companies were behaving more responsibly (Paul & Aquila, 1988). Striving to expand their scope and impact, the CEP later published the book *Rating America's Corporate Conscience* which compiled data and social performance metrics on approximately 130 large corporations (Lydenberg, Marlin, & Strub, 1986). Many of the social and environmental issues evaluated in the book continue to serve as key dimensions of corporate social performance in present-day rating systems.

Another early rating system that achieved notable success was the Sullivan Principles (see Paul & Lydenberg, 1992 for a brief review). Created by Reverend Leon Sullivan in 1977, these principles served as a code of conduct for businesses operating in South Africa and were developed as a way to apply economic pressure on the Apartheid system. Companies that subscribed to the principles were evaluated on an



annual basis using a three-tiered rating system. Unlike previous social monitoring efforts that had focused on single companies (e.g. boycotts), the Sullivan principles achieved considerable success by evaluating a large number of companies on a relative basis (i.e. one to another), and by publicly announcing their progress annually.

By the late 1980s, demand for information and data on corporate social performance was at an all-time high. Sensing an opportunity, many social investment agencies began to publicize and sell their research in the form of corporate social ratings (Paul & Lydenberg, 1992). One such agency was Kinder, Lydenberg, Domini, & Co., Inc. (KLD), later renamed as KLD Research & Analytics, Inc.<sup>7</sup> Established in 1990 by Peter Kinder, Steven Lydenberg, and Amy Domini, KLD was one of the first social investment agencies to publish research designed to evaluate the risks and opportunities associated with corporate environmental and social performance (Cohn & Ball, 2009).

Although the company is today widely known for their corporate social ratings, KLD was initially established on the idea of building an index that would track the costs and benefits of applying social screens to investment decisions (see Godfrey, 2011 for a more detailed review). Up to that point in time, the dominant logic within the industry, particularly among critics, was that investors who followed their conscience would do so at a cost; that narrowing the number of firms within a particular investment pool would limit an investor's return. While she did not necessarily refute this claim, Amy Domini, a long-time social investment advisor, wanted to be able to objectively address investors' concerns by establishing the true costs of social investing. Accordingly, she and her husband, Peter Kinder, began the arduous process of building their own stock index that would provide Domini a benchmark from which to sell her services.

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<sup>7</sup> KLD was acquired by RiskMetrics Group (RMG) in 2009. RMG was later acquired by MSCI in 2010.

Although the idea of an index that tracked socially responsible companies generated substantial interest, most investors were not comfortable with the seemingly subjective process of Domini hand-picking stocks (Godfrey, 2011). To resolve these concerns, Domini and Kinder recruited an old friend, Steve Lydenberg to help build a research database and design the methodology and overall structure of the index. Lydenberg had worked for a number of years with the CEP as well as Franklin Research and Development Corporation. As a co-author of the highly influential book *Rating America's Corporate Conscience* published by the CEP, Lydenberg had substantial expertise in the evaluation of corporate social and environmental performance.

To build credibility and familiarity with investors, KLD sought to establish a methodology of choosing stocks similar to that of other popular indices, in particular the Standard & Poors 500 Index (S&P 500). Like the S&P 500, which was maintained at 500 companies at all times, KLD constructed an index that would also maintain 400 companies at a time. Stocks were also chosen by committee, thus matching the S&P policy of maintaining indexes by committee (Godfrey, 2011). Using the information from their research database, the committee then applied a series of social and environmental screens to the S&P 500, eventually generating a list of 250 firms. An additional 150 firms were added to the index, 100 from underrepresented industries as well as 50 smaller firms that had a strong social mission such as Ben and Jerry's Homemade Inc. After months of diligent work, the index, formally called the Domini Social Index or the Domini 400, was officially launched in May 1990.

Initially, the research database was seen as a tool that would facilitate the production and maintenance of the Index (i.e. a means to an end). The founders, however, soon realized that their most valuable product was the database. Accordingly, KLD quickly shifted their marketing strategy from providing investment

services via the fund to selling their research. While success came slowly at first, the company built up to \$150 million in assets under management by 1995 (Godfrey, 2011). Benefiting from the stock market boom of the 1990s and lacking any significant competition, the KLD ratings quickly became the “de facto standard” for research on corporate social and environmental performance (Waddock, 2003, p. 369). Although a number of new ratings schemes have emerged in recent years,<sup>8</sup> KLD’s ratings continue to be the largest and most widely used multidimensional corporate social performance (CSP) database available to the public (Chatterji & Toffel, 2010; Chen & Delmas, 2011; Deckop, Merriman, & Gupta, 2006; Graves & Waddock, 1994; Sharfman, 1996; Turban & Greening, 1997; Waddock, 2003).

### **A Description of the KLD Ratings**

As an independent rating agency, KLD provides annual evaluations of the environmental, social, and governance performance of large public corporations based in the U.S. KLD first began to issue ratings in 1991 to members of the S&P 500 Index and the Domini Social Index. They later expanded their coverage to include the largest 1,000 US companies by market capitalization in 2001 and the largest 3,000 companies by the same measure in 2003 (“MSCI ESG STATS: User Guide & ESG Ratings Definition,” 2012). Companies rated by KLD receive over 50 different ratings across seven distinct categories, which include the environment, community, human rights, employee relations, diversity, customers, and governance. To facilitate exclusionary screening, KLD also provides ratings on the following controversial business issues: Alcohol, Gambling, Firearms, Military, Nuclear Power, and Tobacco.

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<sup>8</sup> According to one recent report, there exist more than 100 independent corporate social ratings, with more than eighty percent emerging after 2000 (Sadowski et al., 2010).

Each rating is constituted by a binary variable that indicates whether the company has met certain criteria established for the rating. Some ratings are categorized as strengths (e.g. charitable giving, clean energy, minority representation, etc.) while others are categorized as concerns (e.g. substantial emissions, negative community impact, health and safety concerns, etc.). Both the strength and concerns ratings can be thought of as positive and negative screens which allow social investors to include or exclude certain companies based on certain environmental, social, and governance criteria (Kurtz, 2008). Ratings also differ in their degree of ambiguity. Some ratings, for example, specify clear standards of performance for inclusion while others are relatively ambiguous leaving substantial uncertainty about what might be required to achieve the rating.<sup>9</sup>

KLD's ratings are based on publicly available information as well as information directly collected from the company (Chatterji & Toffel, 2010). When possible, KLD uses quantitative criteria to determine a rating to eliminate subjective judgment (Waddock & Graves, 1997). A group of experts meet regularly to discuss borderline cases (Godfrey, 2011). Prior to being published, ratings are sent to executive managers for review, thus giving firms an opportunity to respond to any discrepancies before the rating is made public (Godfrey, Merrill, & Hansen, 2009). While few have raised questions about the quality and credibility of the data (Chatterji & Levine, 2006; Entine, 2003),<sup>10</sup> a number of researchers have found empirical

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<sup>9</sup> For example, firms that give at least 1.5% of their pre-tax earnings to charity receive a positive rating for charitable giving. Such a rating creates an unambiguous standard of performance that is known by the firm. On the other hand, firms that develop and sell innovative products with environmental benefits are also recognized by KLD. Unlike the positive rating for charitable giving, however, the rating for beneficial products and services does not specify an absolute standard of performance required for recognition.

<sup>10</sup> Scholars, for example, have argued that the common practice of aggregating individual performance ratings into larger constructs such as corporate social performance (CSP) destroys the information value contained in finer-grained measures (Godfrey et al., 2009; Hillman & Keim, 2001; Mattingly & Berman, 2006). In this study, I avoid this problem by evaluating how firms respond to individual items

support for the construct and historical validity of the ratings (Chatterji et al., 2009; Mattingly & Berman, 2006; Sharfman, 1996), further enhancing their legitimacy and credibility.

According to KLD, their primary mission in issuing social ratings has always been to provide “management tools to professionals integrating environmental, social, and governance factors (ESG) into their investment decisions” (Chatterji & Toffel, 2010, p. 920). Underlying this objective, however, is the assumption that revealing previously unknown information will create external pressures that motivate companies to improve (Doshi et al., 2013; Fung et al., 2007; Graham, 2000). Highlighting this implicit objective, Paul and Lydenberg noted that

*These systems clearly have an implicit social agenda [emphasis added], one in which certain corporate characteristics or actions are deemed “better” than others. By publicizing assessments of how corporations rate relative to each other on these issues, these ratings systems intend to push corporate management to improve its rating—that is, these systems are intended not only to influence consumer or employee choices, but also, and of even greater importance, to directly influence corporate behavior. (1992)*

Although KLD has never explicitly declared their intentions to pressure companies, statements made by its founders indicate that they too understood the magnitude of impact these ratings could have on corporate behavior.<sup>11</sup> For example, when asked about the long-term goals of the KLD ratings, Domini stated, “Our interest is *to increase corporate accountability [emphasis added]. The goal here is to have an impact.* I think that’s the big shift in social investing. Historically it was sin avoidance and now it’s *another voice for social change*” (Gumbel, 1991). Lydenberg likewise noted that social ratings were an effective market mechanism for guiding

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ratings that can be linked directly to a specific performance dimension.

<sup>11</sup> For further corroboration, see Appendix B: Interview with Steven Lydenberg.

“corporations to the public interest” (2005, p. 1). Although perhaps less ideologically driven, even Kinder acknowledged that the ratings could have an impact and “importance that really transcended what [their] original purpose had been” (Godfrey, 2011, p. 7).

### **Empirical Context: The Impact of Positive Recognition on Subsequent Charitable Contributions**

Despite KLD’s implicit intentions to increase corporate accountability, to date, only one study has empirically examined whether social ratings actually lead to improvements in social or environmental performance (see Appendix A for a complete literature review). Relying on an exogenous shock that occurred when KLD expanded the scope of their ratings in 2001, Chatterji and Toffel (2010), found that firms that initially received poor environmental ratings subsequently reduced their release of toxic emissions compared to other firms. Based on these results, one could effectively conclude that firms respond to negative social ratings by improving their subsequent social performance.

Not all ratings agencies, however, seek to motivate improvements in corporate responsibility by way of embarrassment or shame (Graham, 2000). In fact, many social rating agencies, like KLD, seek to motivate improvements by implicitly or explicitly recognizing and rewarding firms that exhibit exceptional levels of social performance and responsible behavior. The magazine *Business Ethics*, for example, has since the year 2000, published an annual “100 Best Corporate Citizens” list with the explicit objective of “pushing the envelope on what represents good corporate citizenship” and “moving corporations towards better practices” (Waddock et al., 2000, p. 17). Yet despite these proactive objectives, the majority of research has given little consideration to whether positive ratings might motivate improvements in

corporate social performance. Highlighting this gap in our understanding, Chatterji and Toffel (2010, p. 933) stated that “further research is needed to understand how organizations respond to positive ratings.”

In accordance with this call, I investigate how positive social ratings influence subsequent corporate social performance. While KLD has rated firms across several dimensions of social performance, for this study, I focus on one particular rating that evaluates a firm’s charitable giving practices. Taking advantage of an exogenous shock that occurred when the ratings were first issued in 1991, I examine how the introduction of a new standard of giving influenced subsequent corporate charitable contributions. Seeking to not only address the question about how firms respond to positive recognition but also when, I also address how various institutional, organizational, and managerial factors might amplify or dampen firm response.

## **CHAPTER 4: THE IMPACT OF POSITIVE RECOGNITION ON SUBSEQUENT CHARITABLE CONTRIBUTIONS**

In recent years, scholars have demonstrated an increasing interest in understanding how organizations respond to ratings. Although much of this work has analyzed how organizations respond to negative ratings (Chatterji & Toffel, 2010; Elsbach & Kramer, 1996; Espeland & Sauder, 2007; Jin & Leslie, 2003), limited attention has been paid to the performance effects of positive ratings. Understanding whether organizations respond to positive ratings is important, however, as many rating agencies believe that recognizing past superior performance is an effective way to motivate subsequent improvements.

Underlying this belief are two implicit assumptions. First, it is commonly assumed that positive recognition will bring favorable attention and reputation to high-performing firms which will then encourage imitation or improvement by low-performing firms (Fombrun, 1996). Second, past theoretical work within the economic tradition suggests that firms recognized for their past superior performance have strong incentives to maintain consistent performance in the future as a decrease in performance may result in the loss of reputation which can impose long-term costs on the firm (Fombrun, 1996; Klein & Leffler, 1981; Noe, 2012; C. Shapiro, 1983). Together these assertions suggest that positive recognition will lead to improvements in firm behavior and performance, particularly among the unrecognized firms.

Contrary to these assumptions, in this study, I seek to demonstrate that the introduction of third-party ratings that recognize past superior performance can, under certain conditions, lead firms to reduce their subsequent performance. Drawing upon the tenets of behavioral and performance feedback theory (Cyert & March, 1963; Greve, 2003b), I argue that positive ratings that define a specific threshold for



recognition reduce uncertainty about what constitutes an acceptable or appropriate level of behavior. Assuming that firms seek to avoid uncertainty and are limited in their ability to consider all possible strategies and outcomes (Argote & Greve, 2007; Cyert & March, 1963; Gavetti, Greve, Levinthal, & Ocasio, 2012), I maintain that positive ratings can lead recognized firms to perceive the new standard of performance as a satisfactory and acceptable benchmark to attain. Such changes in perceptions, I argue, will lead these firms to redefine their aspirations and thus reduce their subsequent performance.

I evaluate this main premise, as well as several boundary conditions, by examining how firms respond to social ratings that recognize their philanthropic efforts. Corporate philanthropy is an ideal context in which to study the effects of ratings on organizational aspirations. Because they face substantial uncertainty about how much they should donate (Galaskiewicz, 1985, 1997; Galaskiewicz & Wasserman, 1989), firms often use decision rules to determine the appropriate level of giving. While prior research suggests that aspirations for giving are determined based on the firm's past levels of giving as well as the giving of local peers (Marquis, Glynn, & Davis, 2007; McElroy & Siegfried, 1986; Useem & Kutner, 1986), here I argue that positive ratings that define a specific performance threshold can directly alter an organization's aspirations for giving and thus lead recognized firms to reduce their subsequent contributions.

This chapter is outlined as follows. First, I briefly review the basic concepts and assumptions of a behavioral perspective. I then provide a short description of corporate philanthropy, focusing specifically on the primary motives for giving and how decisions about corporate giving are made. Following this description, I then propose a series of hypotheses that predict how and when firms will respond to being

rated as a charitable organization. The data and methods used to test these hypotheses will be covered in the following chapter.

### **Theoretical Foundations**

The origins of behavioral theory can be traced back to an intellectual movement that occurred within economics during the 1950s. Known as the Carnegie School, this new theoretical paradigm emerged as a “frontal assault” on the prevailing assumptions of the economic theory of the firm (Cyert & March, 1963, p. 8).<sup>12</sup> Central to the Schools’ mission and identity were three basic premises: (1) that organizations should be the ultimate object of study, (2) that the scientific study of firm behavior and administration should focus on understanding the internal workings of an organization through closer examination of organizational decision-making, and (3) that theoretical models should exhibit behavioral plausibility, that is, that models should mirror empirical reality (Gavetti et al., 2012). While a focus on the organization as the primary unit of study was shared by most economists, the behavioral theory of the firm differed from the economic theory of the firm in a number of ways, most notably through its reconceptualization of human rationality.

A central contribution of the theory is its reconceptualization of human rationality. Underpinning most economic theories is the rational choice paradigm, which assumes that economic actors operate with full knowledge of all possible choices and can therefore rationally weigh the costs and benefits of various alternatives and thus maximize their respective utilities. Contrary to this assumption, behavioral theorists hold that human decision makers possess bounded rationality and are, as a result, significantly constrained in their ability to process and calculate

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<sup>12</sup> Many of behavioral theory’s seminal propositions and predictions were initially developed in the Schools’ three foundational works, *Administrative Behavior* (H. A. Simon, 1947), *Organizations* (March & Simon, 1958), and most notably, *A Behavioral Theory of the Firm* (Cyert & March, 1963).

information (Cyert & March, 1963; March & Simon, 1958; H. A. Simon, 1957). Instead of maximizing, organizational decision makers are thought to simplify the search for solutions by satisficing, which means that they seek solutions that are deemed to be satisfactory or acceptable, but not necessarily optimal.

Consistent with the notion of satisficing is the assumption that organizational decision makers seek to avoid uncertainty by resorting to coping mechanisms that reduce cognitive effort and reduce the need to anticipate the future (Cyert & March, 1963). Such mechanisms usually take the form of decision rules, standard operating procedures or routines, which specify how organizations should behave (Gavetti et al., 2012; Nelson & Winter, 1982). Another way organizations avoid uncertainty is by creating a negotiated environment. Instead of treating the environment as an exogenous factor that must be predicted, firms “seek ways to make it controllable” (Cyert & March, 1963, p. 168). Firms, for example, can reduce uncertainty about a competitor’s actions by sponsoring the creation of industry-wide standards. Internal planning processes, such as budgets, can likewise provide an internal negotiated environment.

Behavioral theory also places a particularly strong emphasis on understanding the formation of organizational goals and how these goals influence subsequent behavior and performance. Organizations are assumed to have wide range of goals, including profit, production, and even prestige (Cyert & March, 1963) that vary in importance and priority. Goals are chosen and implemented based on the interests and authority of the dominant coalition (generally assumed to be the top management team) and thus assigned to workers throughout the organization. Some goals, such as those surrounding firm profitability, have no upward bound and are therefore considered to be maximization goals. Other goals, like production and prestige, are

conceptualized as sub-goals that are subject to the constraints of more important goals, like firm profitability.

While some organizational goals are aligned, others are inherently in conflict with one another. Cyert and March (1963, p. 146), for example, noted that “most organizations exist and thrive with a considerable latent conflict of goals.” Such conflicts are likely to be resolved through satisficing mechanisms such as sequential attention, which are decision rules that permit decision makers to attend to one goal at a time. These decision rules reduce conflict and cognitive effort by allowing decision makers to treat different goals as “constraints to be satisfied in some order of priority rather than as trade-offs that have to be weighed against each other” (Greve, 2008, p. 480).

Building upon this behavioral framework, recent research has sought to understand how organizational performance influences subsequent strategic decisions (Greve, 2003b). Known as performance feedback theory, this perspective argues that managers evaluate their organization’s performance relative to a goal or aspiration level (Greve, 2003a). Often defined as a “reference point that is psychologically neutral” (Kameda & Davis, 1990, p. 56), or “the smallest outcome that would be deemed satisfactory by the decision maker” (Schneider, 1992, p. 1053), an aspiration level is the result of a boundedly rational decision maker seeking to simplify performance feedback by “transforming a continuous measure of performance into a discrete measure of success or failure” (Greve, 1998, p. 59).

Once an aspiration level is set, organizational decision makers then use it as a reference point in evaluating performance (Greve, 2003a). When performance falls below the aspiration level, organizations engage in problemistic search by seeking out solutions that will drive subsequent increases in performance (Cyert & March,

1963).<sup>13</sup> Failure to achieve the aspiration also increases tolerance for risk as managers are likely to view poor performance as a loss (Kahneman & Tversky, 1979) and will therefore be more willing to take risks to improve (Bromiley, 1991; Lant, Milliken, & Batra, 1992). When performance exceeds the aspiration level, managers' preferences for risky actions decrease (Greve, 2003b; March & Shapira, 1987; Singh, House, & Tucker, 1986). Such risk aversion can lead high-performing organizations to continue the status quo thus reducing the likelihood of organizational change (Greve, 1998, 2003b).

Prior research within the behavioral tradition suggests that aspirations are formed based on the organization's past performance and the performance of similar others (Cyert & March, 1963; Greve, 1998, 2003a, 2003b). Less well understood, however, is how institutional elements from the external environment influence the formation of organizational aspirations (Gavetti et al., 2012; Gavetti, Levinthal, & Ocasio, 2007; Shinkle, 2012). Indeed, scholars have noted that third-party ratings can *indirectly* alter organizational aspirations by providing information that facilitates social comparison (Greve, 2003b). In this study, I extend behavioral theory by proposing that ratings can serve as a *direct source of performance feedback* to which firms respond. By redefining standards of appropriate and acceptable behavior, such ratings can directly alter organizational aspirations and thus lead high-performing firms to reduce their subsequent performance. Although evaluating organizational aspirations directly is an inherently difficult process,<sup>14</sup> I can, nevertheless, observe

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<sup>13</sup> Not all search activities are initiated by performance shortfalls. For example, increased organizational slack, often created by high past performance, can allow greater experimentation and organizational change (Cyert & March, 1963; March, 1981). Other search activities, such as research and development, are institutionalized within organizations, and therefore occur as a planned result of the strategic planning and resource allocation process (Greve, 2003b).

<sup>14</sup> According to one recent review of the literature, the overwhelming majority of empirical articles infer organizational aspirations based on historical and social factors. Because of data limitations, few are able to observe these aspirations directly (Shinkle, 2012).

whether firms behave in a manner consistent with my predictions. Confirmation of these predictions would suggest that efforts to promote improvements in behavior and performance through positive recognition can paradoxically lead to the opposite effect.

### **Empirical Context**

As introduced in Chapter 3, I test my main argument, and several moderating effects, using social ratings data from the KLD STATS database, the largest and most widely-used corporate social performance database available to the public (Deckop et al., 2006).<sup>15</sup> Although KLD rated firms across several dimensions of social performance, for this study, I focus on one particular rating that evaluated a firm's charitable giving practices.<sup>16</sup>

A positive rating was given to firms that had consistently given over 1.5 percent of trailing three-year net earnings before taxes, or had otherwise been notably generous in their giving. Because the rating was binary assessment, it could also be thought of as an accreditation, which has been defined as a non-rival assessment that compares economic actors against a fixed standard of performance (Deephouse & Suchman, 2008; Graffin & Ward, 2010). Although KLD did not explicitly describe their ratings as performance standards, implicit in their work was the assumption that defining a specific performance threshold would serve as a goal or baseline level of performance for unrecognized firms to achieve.<sup>17</sup>

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<sup>15</sup> This database is now known as the MSCI STATS database. KLD Research & Analytics, Inc. was acquired by the Risk Metrics Group in 2009, which was then acquired by MSCI in 2010.

<sup>16</sup> My reasons for focusing on the charitable giving rating were primarily instrumental. First, the charitable giving rating issued by KLD was one of the few ratings that defined a specific performance standard. Second, the level of charitable giving, the dimension of performance evaluated by the rating, was also relatively easy to collect and evaluate.

<sup>17</sup> See Appendix B: Interview with Steven Lydenberg for corroborating evidence.

## **Overview of Corporate Philanthropy**

Corporate philanthropy can be defined as the voluntary, unreciprocated, or unilateral transfer of wealth to private nonprofit organizations (Atkinson & Galaskiewicz, 1988; Fry, Keim, & Meiners, 1982; Galaskiewicz & Wasserman, 1989; Godfrey, 2005).

Typically such transfers involve gifts or monetary contributions to various domains of social or public interest including the (1) arts and culture, (2) civic and public benefit, (3) education, and (4) health and human welfare (Marquis et al., 2007; Wang & Qian, 2011). Although studied from a variety of theoretical perspectives, corporate philanthropy is generally considered a component or sub-dimension of several closely related theoretical constructs including corporate social responsibility (CSR) (Godfrey, 2005), corporate social action (CSA) (Marquis et al., 2007), and corporate social performance (CSP) (Margolis, Elfenbein, & Walsh, 2007).

While the earliest record of corporate charitable contributions dates back to railroad boom of the late 1800s, it wasn't until 1935 that the use of corporate funds for altruistic purposes was recognized as legal by the federal government (Andrews, 1952). Such an endorsement, however, did not fully settle the legality of corporate contributions as corporations were organized under state law, not federal law.

Uncertainty regarding the legal status of corporate contributions thus continued until 1953 when the Supreme Court of New Jersey ruled that corporations were free to give to charities whether or not such donations were related to the business of the company (Muirhead, 1999). By the mid-1950s, other state courts followed suit. Together, these rulings helped to dispel corporate concern regarding the legality of their philanthropic actions. Corporate contributions increased dramatically as a result (Muirhead, 1999).

Despite being a legal and institutionalized practice today, particularly among large public companies, corporate philanthropy continues to be a highly contested

issue (Karnani, 2010).<sup>18</sup> Proponents of the shareholder maximization logic, for example, vigorously maintain that corporate philanthropy is an exploitation of shareholder value and that corporations contribute the most to social welfare through the production of economic goods, not charitable donations (Friedman, 1970; Jensen, 2002; McWilliams & Siegel, 2001). Although some have embraced strategic philanthropy as a way to address important social and economic goals simultaneously (Godfrey, 2005; Porter & Kramer, 2002), tensions between the firm's social and economic objectives continue to remain. Highlighting this tension, Margolis and Walsh note:

Corporate efforts to respond to social ills are not only in conflict with other objectives, they are themselves inherently provocative, highlighting in their very purpose their inconsistency with the firm's economic objective. Therefore, these corporate efforts pose distinct management challenges. Ameliorative initiatives are simultaneously legitimacy-seeking and legitimacy-threatening acts, adhering to one set of expectations, social in nature, while violating another, economic in nature. (2003, p. 288)

Although companies may give for a variety of reasons, the majority of the extant research on philanthropy suggests that firms are motivated to give in order to (1) obtain legitimacy by meeting some minimum standard of acceptability or (2) build their reputational capital by distinguishing themselves from their peers (King & Whetten, 2008). A number of studies, for example, have demonstrated how corporations, in their quest for legitimacy, align their social practices with the norms and standards that emanate from local communities (Galaskiewicz, 1997; Guthrie, 2003; Marquis et al., 2007; Tilcsik & Marquis, 2013). Other studies have found charitable giving to be positively related to advertising expenses and degree of customer contact (Burt, 1983; Fry et al., 1982; Navarro, 1988), suggesting that firms

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<sup>18</sup> According to Scott, "legitimate structures may, at the same time, be contested structures" (2008, p. 61).



give in order to increase their reputation among consumers. One recent stream of literature posits that rather than *generating* shareholder value, philanthropic activities build a form of good will or moral capital that acts as a form of insurance to *preserve* the firm's intangible assets (i.e. brand, reputation, public image, etc.) (Godfrey, 2005; Godfrey et al., 2009; Koh, Qian, & Wang, 2013). While conceptually distinct, all of these perspectives are aligned with the ideology of "enlightened-self-interest" (Galaskiewicz, 1985, 1997; Galaskiewicz & Burt, 1991), the idea that giving benefits the long-term interests of the firm.

Corporate donations are typically given indirectly through corporate foundations or directly through corporate giving programs. Foundations are legally separate entities that exist to pursue the philanthropic activities of its parent company (Marquis & Lee, 2013). Having a foundation enables firms to (1) smooth its giving over time in order to maintain steady levels of goodwill (Wolch, 1995), (2) maintain the independence of philanthropic decisions from other business decisions (Siegfried, McElroy, & Biernot-Fawkes, 1983), and (3) meet the external demands by stakeholders for internal accountability and control (Himmelstein, 1997).

Relevant decisions within the context of corporate philanthropy include the focus, form, and level of charitable contributions (Marquis et al., 2007).<sup>19</sup> For this study, I focus on the level of cash contributions, as ratings regarding corporate generosity most often evaluate the level of cash contributions as the primary criterion for distinguishing between generous and non-generous firms.

Managers and top executives have been known to have considerable influence over the frequency, levels, and targets of charitable contributions. A number of

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<sup>19</sup> The focus describes the particular domain of social problems or needs that the contributions are intended to mitigate or benefit (e.g. supporting the arts, education, health, etc.). The form of charitable contribution can be categorized as cash donations either directly by the company or indirectly through a foundation, or in-kind donations of products and services. The level of charitable contributions refers to the amount of contributions.

studies, for example, have demonstrated a strong relationship between managerial characteristics and firm-level philanthropic behaviors (Atkinson & Galaskiewicz, 1988; Buchholtz, Amason, & Rutherford, 1999; Marquis & Lee, 2013; Siegfried et al., 1983). Relationships with other leaders of other firms and non-profit organizations have also been shown to strongly influence the allocation and disbursement of corporate philanthropic donations (Galaskiewicz, 1985, 1997; Useem & Kutner, 1986; Werbel & Carter, 2002).

Although a number of scholars have argued that corporate philanthropic donations are an increasingly strategic and salient component of business social performance (Brammer & Millington, 2008; Godfrey, 2005; Porter & Kramer, 2002), charitable contributions are nevertheless discretionary expenditures often subject to the whim of managers and the constraint of financial resources (Buchholtz et al., 1999; Carroll, 1979). Such discretion arises because of the uncertainty that managers face in measuring and evaluating the costs and benefits of corporate donations (Galaskiewicz, 1997). Such uncertainty, I argue, is also crucial to understanding firm response to ratings.

## **Hypotheses**

### **Firm Response to Positive Ratings**

How much should firms give to charity? Standard economic reasoning suggests that firms should contribute at a level that meets a bare minimum for deriving benefits for the firm (Friedman, 1970). Drawing upon the economics of insurance, the risk management perspective likewise proposes that managers should engage in philanthropic activity that generates an optimal level of moral capital to insure the firm's intangible assets (Godfrey, 2005). Indeed, both perspectives provide an "clear

conceptual stopping rule” in determining the optimal level of philanthropic activity (Godfrey, 2005, p. 791).

Despite the simplicity and clarity of these arguments, prior research suggests that managers may lack the necessary information required to calculate the optimal level of philanthropic activity (Galaskiewicz, 1997). One reason for this lack of information can be attributed to the delays in feedback caused by inherent structure of the grants economy. As noted by Galaskiewicz and Wasserman,

In contrast to market economies, in which actors can tell if they are better or worse off in a given transaction, in a grants economy the donor does not see or experience benefits until far into the future. Thus although donors may have preferences, feedback comes so slowly that donors often do not have the information they need to rechannel their resources to realize a more beneficial and efficient (i.e., less costly) outcome. (1989, p. 457)

While delays in information feedback may indeed complicate the cost-benefit analysis of charitable contributions (Sinclair & Galaskiewicz, 1996), some managers may still be motivated to give by the belief that giving to charitable causes will somehow benefit the long-term interests of the firm (Davis, 1973; Galaskiewicz, 1985, 1997).<sup>20</sup> Such beliefs, however, only confirm the assertion that managers know very little about the short-run consequences of their giving. Furthermore, recent reviews of the literature have found inconclusive evidence that higher levels of charitable giving actually lead to increased financial performance (Margolis & Walsh, 2003).<sup>21, 22</sup>

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<sup>20</sup> Known as “enlightened self-interest,” this rationale was popular among corporate executives during the late 1970s and early 1980s (Galaskiewicz, 1997).

<sup>21</sup> After performing a one recent meta-analysis, Margolis and Elfenbien summarized their findings as follows: “While doing good doesn’t appear to destroy shareholder value, we found only a very small correlation between corporate behavior and good financial results” (2008, p. 19).

<sup>22</sup> Seeking to explain these mixed results, more recent empirical studies have proposed a non-linear relationship between corporate philanthropy and financial performance. Even these attempts, however, have produced mixed results. Brammer and Millington (2008), for example, found that firms with both unusually high and low charitable contributions had better financial performance than those making an intermediate level of contributions. In contrast to these findings, Wang, Choi, and Li (2008) found an

Collectively, these arguments suggest that firms are unlikely to know with certainty the economic consequences of their philanthropic activities. This lack of knowledge creates substantial uncertainty surrounding how much firms should give in order to achieve their reputational or legitimacy goals.

From a behavioral perspective, firms are thought to manage uncertainty by resorting to coping mechanisms that reduce the need to anticipate distant futures (Cyert & March, 1963; Gavetti et al., 2012). Such mechanisms include satisficing decision rules that emphasize short-run responses to feedback and attempts to create a negotiated environment through coordination with external actors. Summarizing these arguments, Cyert and March maintain that firms “achieve a reasonably manageable prediction by avoiding planning where plans depend on predictions of uncertain future events and by emphasizing planning where the plans can be made self-confirming through some control device” (1963, p. 119).

In the case of corporate philanthropy, firms manage uncertainty about how much they should donate by relying on budgets and community norms. One survey of firms, for example, indicated that 90 percent of respondents determine the level of charitable contributions as part of their annual budget (McElroy & Siegfried, 1986). Others have argued that standards regarding the appropriate level of charitable contributions are embedded within local communities and that such standards vary by community, depending on the presence and density of local civic networks and institutions (Marquis et al., 2007). Both of these decision rules correspond closely with the notion that a firm’s aspiration levels, or goals, are formed and determined by historical and social factors respectively (Cyert & March, 1963; Greve, 1998, 2003b).

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inverse U-shaped relationship between corporate philanthropy and financial performance.

Such decision rules, however, may only reduce the uncertainty temporarily as firms are likely to revisit the decision year after year (Marquis et al., 2007).

The exogenous introduction of a rating that establishes a fixed standard of performance for giving can also reduce uncertainty by establishing a baseline-level of performance that needs to be met in order to be recognized as a charitable firm. Like budgets and social comparisons, such ratings can become decision rules for firms to follow, particularly when the information required to make fully rational decisions is unavailable or difficult to obtain (Gavetti et al., 2012). In many ways, positive ratings that specify a new fixed standard may be superior to alternative decision rules as they do not require firms to revisit the decision each year and thus reduce the costs of information search and cognitive processing (Bitektine, 2011). Indeed, complete acceptance of the new performance standard as satisfactory and acceptable goal would be entirely consistent with the notion that firms will negotiate a structured environment in order to eliminate the uncertainty (Cyert & March, 1963).

Positive ratings are also likely to bring substantial recognition and prestige to high-performing firms. Reputation scholars, for example, have argued that favorable ratings from expert intermediaries “impact the prominence of an organizations by certifying their achievement relative to explicit or implicit standards in given field” (Rindova et al., 2005, p. 1038). Such ratings are especially valuable in contexts, like corporate philanthropy, where the qualities and capabilities of a firm are difficult to assess (Graffin & Ward, 2010).

Because positive ratings reduce cognitive effort and increase organizational reputation, I thus expect that recognized firms will be more likely to perceive the new standard as a satisfactory and acceptable benchmark to attain. Assuming that managers are boundedly rational (Cyert & March, 1963; H. Simon, 1957), just meeting the benchmark may in fact be the optimal response as high-performing firms can secure

their reputation as a charitable organization while simultaneously reducing costs (Margolis & Walsh, 2003). Given these arguments, I thus predict that high-performing firms whose prior level of giving exceeds the new rating threshold will decrease their subsequent philanthropic contributions.

*Hypothesis 1: Firms recognized for their charitable giving will subsequently decrease their philanthropic contributions more than other firms.*

### **The Moderating Effects of Institutional and Organizational Characteristics**

While accepting this new performance standard as an aspiration or goal would presumably be an attractive option to all firms recognized for their past generosity as it reduces uncertainty about how much they should give, the perceived costs and benefits of doing so may vary depending on various institutional and organizational factors. Previous work, for example, has noted that firm response to negative ratings is moderated by the effects of regulatory stringency and organizational efficiency (Chatterji & Toffel, 2010). Here I examine the effects of local communities, resource dependence, industry-specific risk, and financial performance.

*Normative Pressures from Local Communities.* Prior research on patterns of charitable giving suggests that many firms face substantial local pressures to engage in corporate philanthropy. In a national survey of 2,776 companies, Guthrie (2003), for example, found that 91 percent of companies reported strong to moderate local norms for philanthropic activities. This finding is in line with other previous work that highlights the influence of local communities on corporate behavior (Kono, Palmer, Friedland, & Zafonte, 1998; Lounsbury, 2007; Marquis, 2003; Marquis & Battilana, 2009; Marquis et al., 2007).

Some of these normative pressures may arise from local institutions such as civic involvement groups (Marquis et al., 2007). Galaskiewicz (1985, 1997; 1991), for

example, described how business and community leaders in Minneapolis established the “5-Percent Club,” a tithing club that expected its members to give 5 percent of before-tax profits to charity. Members that met the high standard were recognized at an annual luncheon by their peers and the public. Such recognition arguably incentivized and encouraged philanthropic activity in the community and helped to build the firm’s reputation among local community stakeholders. Supporting this assertion, Navarro (1988), found that the average contribution-to-sales ratio was twice as high for firms in cities with tithing clubs versus cities without tithing clubs.

Firms may also feel pressure to contribute from their local peers. McElroy and Siegfried (1986), for example, found that the level of giving is significantly influenced by other firms within the local community. Communities with dense social networks are also effective at mobilizing social pressure for compliance with local norms (Galaskiewicz, 1985). Thus when faced with a decision about how much to donate, “the right answer hinges on the opinions of peers to whom the actor is socially connected” (Marquis et al., 2007).

Given these findings, I propose that firms headquartered in charitable communities that are recognized for their philanthropic efforts will be less likely to reduce their subsequent charitable contributions. Charitable communities are likely to have strong social norms and networks that may generate expectations for giving that lie above the rating threshold. Because firms seek to resemble other organizations within their local communities (Marquis et al., 2007), such norms would likely discourage recognized firms from reducing their contributions.

*Hypothesis 2: Firms recognized for their charitable giving will be less likely to decrease their philanthropic contributions when headquartered in communities with strong norms for giving.*

*Consumer Orientation.* Firm response to positive recognition may also be influenced by the degree to which firms are dependent on a positive reputation or public image. Because they sell directly to customers, firms operating within the consumer sector are likely to be more sensitive about their public image and therefore have greater incentives to make investments that will increase their reputation.

One way firms can enhance their reputation is through charitable donations (Brammer & Millington, 2005; Godfrey, 2005). Like advertising, contributions can be used to negotiate favorable corporate images in the eyes of its customers by communicating the firm's message, mission, intentions, and values (Galaskiewicz, 1997; Haley, 1991; Sen & Bhattacharya, 2001). Consistent with these assertions, previous research has demonstrated that firms in industries that depend on consumer sales give more to charitable causes (Burt, 1983; Fry et al., 1982; Navarro, 1988). These same studies have also found significant correlations between advertising and charitable contributions. Finally, scholars have found a positive relationship between the level of giving and firm reputation (Brammer & Millington, 2005; Fombrun & Shanley, 1990).

Given these findings, I thus hypothesize that firms with a stronger consumer orientation will be less likely to decrease their subsequent contributions when recognized for their charitable giving. Because firms primarily operating in the consumer sector depend heavily on their reputation and public image, and because corporate philanthropy has been shown to enhance firm reputation among key stakeholders, consumer-oriented firms that are recognized for their past generosity may continue to give at levels that exceed the new performance standard as a way to distinguish the firm from its peers (King & Whetten, 2008).



*Hypothesis 3: Firms recognized for their charitable giving will be less likely to decrease their philanthropic contributions when doing business in consumer-oriented industries.*

*Socially-Contested Industries.* Recent work within the context of corporate philanthropy has argued that a firm's charitable contributions can provide insurance-like protection for its intangible assets (brand, reputation, public image, etc.) and that this protection helps to *preserve* shareholder wealth (Godfrey, 2005; Godfrey et al., 2009). Known as the risk-management hypothesis, this perspective proposes that two factors determine the optimal level of philanthropic activity: the level of wealth at risk (e.g. the value of the firm's intangible assets) and the level of risk inherent in the firm's operations and activities. While the level of risk surely has a firm-specific component, much of this risk is determined by the industry in which the company operates (Brammer & Pavelin, 2005; Godfrey, 2005).<sup>23</sup> Accordingly, an important prediction from this perspective is that the optimal level of philanthropic activity will be higher for firms with higher industry-specific risk profiles.

Consistent with this prediction, a number of studies have shown that higher-risk industries give more to charity (Brammer & Millington, 2005; Brammer & Pavelin, 2005; Williams & Barrett, 2000). For example, among large public companies in the U.K., Brammer and Pavelin (2005) found that firms operating in "high-risk" sectors contributed to charity at much higher levels than other firms. Furthermore, scholars have found the relationship between industry-specific risk and corporate giving to be particularly strong for firms operating within industries with significant social external ties (e.g. alcohol, tobacco, gambling, firearms, etc.) (Brammer & Millington, 2005). Firms in the tobacco industry, for instance, have been

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<sup>23</sup> For example, firms operating in the mining sector face risks associated with environmental degradation while firms in the oil and gas sector face risks associated with climate change.

known to give generously to charitable causes, presumably as a way to counter negative publicity about its products (Godfrey et al., 2009; Koh et al., 2013).

Given these findings, I thus predict that firms operating in socially-contested industries will be less likely to reduce their subsequent contributions when recognized for their charitable giving. Such firms arguably face a greater likelihood of experiencing a reputational loss given the inherent risks associated with their business operations. Because philanthropy has been argued to provide insurance-like protection against such losses, firms operating in socially-contested sectors that are recognized for their past generosity may continue to give at levels that exceed the new performance standard as way of providing insurance-like protection for their intangible assets.

*Hypothesis 4: Firms recognized for their charitable giving will be less likely to decrease their philanthropic contributions when doing business in socially-contested industries.*

*Prior Financial Performance.* Decisions about the appropriate level of charitable contributions are not solely based on organizational goals of reputation or legitimacy, but are also affected by other relevant organizational goals, in particular goals surrounding firm profitability. Because profitability is considered essential to the survival of any business organization, I expect that financial performance goals will become first priority when the prior financial performance of the firm is low. Since corporate philanthropy is often considered a discretionary activity that is positively associated with organizational slack (Buchholtz et al., 1999; Dennis, Buchholtz, & Butts, 2007), corporate responses to social needs are likely to be in conflict with the firm's economic objective when the firm is performing poorly (Margolis & Walsh, 2003). Such goal conflicts are thought to be resolved through sequential attention

(Cyert & March, 1963), a rule which states that decisions makers attend to one goal at a time. According to Greve (2008), the order in which goals are attended to is not uniform across firms and may change over time depending on the preferences of the dominant coalition. When financial performance is low, however, profitability goals are likely to take first priority until performance goals are met. Given these assertions, I would therefore expect that when prior financial performance is low, firms rated as a charitable organization will shift their resources towards profitability goals, and thus reduce their subsequent charitable contributions. Such reductions will occur because the rating likely serves as a signal that the firm's reputational goals have been met.

On the other hand, prior research has shown that past organizational success can lead to strategic persistence. Some scholars suggest that organizations tend to repeat actions that are associated with positive outcomes (Cyert & March, 1963; Prahalad & Bettis, 1986). Others suggest that organizations become committed to retaining proven competencies (Levitt & March, 1988). In one controlled experiment, researchers found that past success increased decision makers' confidence that their current course of action was correct (Audia, Locke, & Smith, 2000). Given these findings, I therefore predict that when prior financial performance is high, firms noted for their charitable giving will be more likely to continue their current philanthropic strategies. Such firms, I suspect, may partially attribute their current financial success to their past levels of corporate generosity. On the other hand, firms that are not rated as a charitable organization, but are doing well financially are likely to attribute their financial success to other factors.

*Hypothesis 5: Firms recognized for their charitable giving will be more likely to decrease their philanthropic contributions when past financial performance is low.*

## CHAPTER 5: DATA, METHODS, & RESULTS

In this chapter, I empirically test whether firms recognized as a charitable organization will decrease their subsequent contributions as well as several institutional and organizational factors that could moderate this response. I begin my analysis by first giving a detailed description of the data. I then give a brief overview of the sample and methods. The chapter concludes with the results and additional robustness tests.

### Data

#### Dependent Variable

I evaluated a firm's *philanthropic contributions* using the Taft Directory of Corporate Giving, the National Directory of Corporate Giving, and the National Center for Charitable Statistics (NCCS), data sources on corporate philanthropy that have been used in prior organizational research (Fombrun & Shanley, 1990; Lev, Petrovits, & Radhakrishnan, 2010; Marquis et al., 2007; Marquis & Lee, 2013; Tilcsik & Marquis, 2013; Wang et al., 2008). Philanthropic contributions were defined as the total amount of grants given to charity through a corporate foundation or given by the corporation directly. Because many firms use a fixed percentage of pretax income to decide how much to give to charity (McElroy & Siegfried, 1986), I divided this total by the level of pre-tax income for each firm.<sup>24, 25</sup> Such a transformation facilitates the comparison

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<sup>24</sup> Corporate philanthropy as a dependent variable has been evaluated in a number of different ways. Some studies have used the total amount of contributions (Atkinson & Galaskiewicz, 1988; Galaskiewicz, 1985, 1997; Galaskiewicz & Burt, 1991; Galaskiewicz & Wasserman, 1989; Marquis & Lee, 2013; Tilcsik & Marquis, 2013). Others have scaled philanthropy by total revenue as a way to control for differences in firm size (Brammer & Millington, 2008; Navarro, 1988). In this study, I chose to evaluate corporate generosity as the total amount of contributions as a percentage of pre-tax income in order to maintain consistency with KLD's evaluation practices (see below).

<sup>25</sup> Using pre-tax income as a way to control for differences in firm size can nevertheless create problems for empirical analysis, especially when income falls below zero. Rather than remove these observations from the analysis, however, I instead replaced negative values (approximately 8% of the sample) with

of giving across various firms, as some firms are inherently more profitable than others by virtue of their industry membership.

### **Independent Variables**

I obtained ratings of corporate philanthropic behavior from the KLD STATS database. Used widely in the fields of socially responsible investing (SRI) and corporate social responsibility (CSR), the KLD ratings have been referred to as the “de facto research standard” for academic scholars in these fields (Waddock, 2003). KLD first issued social ratings beginning in 1991 for all members of the S&P 500 Index and the Domini Social Index. Because their decision to initially rate these firms was unrelated to prior firm behavior or performance and because firms had no influence on the decision to be rated, I argue that these initial ratings constitute an exogenous shock.

For this study, I specifically focused on a rating that evaluated a firm’s charitable giving practices. A positive rating was given to firms that have consistently given over 1.5 percent of trailing three-year net earnings before taxes (NEBT), or have otherwise been notably generous in their giving. Firms were given an opportunity to respond to a potential rating before it was made public.

To distinguish between charitable and non-charitable firms, I created a dummy variable, *initial positive rating*, for firms that were recognized for their charitable giving practices in 1991. I also created a dummy variable, *no initial positive rating*, for firms that were rated by KLD, but were not noted for their charitable giving practices.

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predicted values generated through a linear interpolation. Because the total contributions are divided by pre-tax income, empirical problems can also result when pre-tax income is very small. Again, rather than throw out these observations, I replaced levels of giving that exceed 10% of pre-tax profits (less than 1% of the sample) with predicted values generated through a linear interpolation. The 10% threshold was chosen because 10 percent of pre-tax profits is the maximum deduction allowed for corporate charitable contributions. While such transformations reduce the influence of outliers by smoothing levels of giving over time, it is nevertheless important to note that removing such outliers from the analysis did not substantively change the results or conclusions.

These firm-level dummy variables were then interacted with a time-varying dummy variable, *KLD rated*, coded ‘1’ starting in 1992 for the years in which firms that were rated by KLD, and ‘0’ otherwise.<sup>26</sup>

Prior to the issuance of the KLD ratings, there existed few sources of information that would have facilitated the comparison of corporate responsibility across a large number of firms.<sup>27</sup> Indeed, one of the primary motivating drivers behind the establishment of the KLD ratings was the lack of transparency and information regarding corporate social performance.<sup>28</sup> Such a lack of transparency and information made it both difficult and costly for interested stakeholders to make comparisons among firms and thus form reputational beliefs about which firms were more or less responsible. Given these assertions, it is therefore unlikely that any observed response by rated firms would have been caused by any factor other than the KLD rating.

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<sup>26</sup> While the ratings were issued in 1991, I did not expect them to have any significant influence on corporate donations until the following year as inertial factors such as budgets and commitments to nonprofits would have likely constrained an immediate response.

<sup>27</sup> *The Conference Board* issued an annual industry-level survey of philanthropic donations beginning in 1974. While such information allowed firms to benchmark their level of contributions against their industry peers, firms were not individually recognized for superior levels of giving, nor were interested stakeholders able to make comparisons of generosity across a large number of firms. *Fortune* magazine also issued its well-known *Most Admired Companies* ranking beginning in 1983. As a subset of the overall ranking, the magazine evaluated companies on several dimensions of stakeholder interest, including community and environmental responsibility. Only the top and bottom three ranked companies for this particular sub-dimension, however, were actually listed in the magazine. Furthermore, while the level of a firm’s philanthropic contributions would presumably be positively correlated with their responsibility score, companies could demonstrate social and environmental responsibility in many other ways besides corporate donations. Given these factors, it is therefore unlikely that the *Fortune* rankings would have been used as a significant source of information on corporate giving. Sponsored by the CEP, Steven Lydenberg, co-founder of KLD, co-authored a book titled *Rating America’s Corporate Conscience*. Published in 1986, the book compiled data and assessments of various social and environmental practices of corporations, including corporate philanthropy. While these ratings could in many ways be considered the closest predecessors to the KLD ratings, evaluations were nevertheless limited to approximately 100 firms (Godfrey, 2011).

<sup>28</sup> See Godfrey, 2011 as well as Chapter 3 for more information regarding the establishment of the KLD ratings.

## **Moderating Variables**

*Charitable Communities.* Following prior research (Marquis, Davis, & Glynn, 2013; Marquis et al., 2007; Tilcsik & Marquis, 2013), I operationalized a local community as a core-based statistical area (CBSA) established by the Office of Management and Budget. According to the Census Bureau, a CBSA is a “core area containing a large population nucleus, together with adjacent communities having a high degree of economic and social integration with that core.” In his seminal work on corporate philanthropy, Galaskiewicz (1985, 1997) found that local giving was often stimulated by the presence of social clubs dedicated to local giving. Known as tithing clubs, these organizations have been known to exhibit strong, normative pressures for members to donate to the community. Prior research, for example, has found that the average contribution-to-sales ratio is twice as high for firms in cities with tithing clubs versus cities without tithing clubs (Navarro, 1988). I therefore coded *charitable community* as ‘1’ for CBSAs that have tithing clubs, and ‘0’ otherwise.<sup>29</sup> A dummy variable, *non-charitable community* was coded as the inverse of *charitable community*.

*Consumer Orientation.* Following an industry classification utilized in previous studies (Lev et al., 2010; Tilcsik & Marquis, 2013), I partitioned the sample of firms into two categories. Firms whose primary customers were individual consumers were categorized as having a *high consumer orientation*, while firms whose primary customers were other firms were categorized as having a *low consumer orientation*. Categories were based on the firm’s four-digit Standard Industrial Classification (SIC) codes, which identify the line of business best represented by the company’s core operations. As would be expected, firms with a high consumer orientation had significantly higher sales, return on assets, and market value than firms

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<sup>29</sup> Communities with tithing clubs during the window of analysis include Baltimore, Birmingham, Denver, Jacksonville, Kansas City, Louisville, Minneapolis, Norfolk, Phoenix, Rochester, San Francisco, and Seattle (see Navarro, 1988).

with a low consumer orientation. At the time the ratings were issued (fiscal year 1991), the largest high consumer orientation firms (by sales) were General Motors, Ford, and AT&T, while the largest low consumer orientation firms were Exxon, IBM, and Mobil.

*Socially-Contested Industry.* Beyond its qualitative ratings that evaluate various dimensions of corporate social performance, KLD also provides exclusionary screening information for involvement in the following controversial business issues: Alcohol, Gambling, Firearms, Military, Nuclear Power, and Tobacco. Using this data, and following recent work by Koh et al. (2013), I thus created a dummy variable *socially contested industry* for firms that are involved in at least one or more of these controversial business issues. A dummy variable, *non-socially contested industry* was coded as the inverse of the variable *socially contested industry*.

*Prior Financial Performance.* I calculated each firm's prior financial performance by averaging the industry-adjusted return on assets (ROA) for the pre-rating period (1989–1991). A firm with a positive industry-adjusted ROA was considered to be a *high-performance firm*, coded as '1' and '0' otherwise. A dummy variable, *low-performance firm* was coded as the inverse of *high-performance firm*.

### **Control Variables**

I controlled for other factors that might influence corporate philanthropic behavior including regulatory context, financial performance, and organizational size (Atkinson & Galaskiewicz, 1988; Brammer & Millington, 2008; Fry et al., 1982; Galaskiewicz, 1985, 1997; Galaskiewicz & Burt, 1991; Marquis & Lee, 2013; Muller & Kräussl, 2011; Tilsik & Marquis, 2013). I controlled for the regulatory context and other time-invariant factors such as corporate culture and geographic location using firm fixed effects. I also controlled for time-variant factors such as organizational size using the



number of employees, assets, revenue, foundation assets, and financial performance using return on assets (ROA), calculated as income before extraordinary items divided by total assets. Finally, I included year dummies to control for unobserved time-variant factors that affect all firms such as changes in policy or societal norms.

## Methods

### Sample

Because I was interested in how firms responded to their initial KLD ratings, I compared firms first rated by KLD with firms not rated by KLD in the sample period. Including the latter controlled for unobserved factors that could affect the social performance of all, not just rated firms.

The analysis began in 1989, two years before KLD began to rate firms, and extended through 1994. The sample included 458 companies from a wide variety of communities and industries (see Tables 1, 2, and 3). Sample firms met *all* of the following criteria: were listed at least once in the TDCG or NDCG or the TDCG during the pre-rating (1989–1991) and post-rating (1992–1994) period, were members of the S&P 900 Index at some point during the window of observation,<sup>30</sup> and were established public companies during or before 1989. Summary statistics and correlations are provided in Table 4.

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<sup>30</sup> The S&P 900 index is a combination of the large-cap S&P 500 index and the mid-cap S&P 400 index. Together, these indices cover approximately 86% of the U.S. market capitalization.

**Table 1. Sample breakdown: Full and split samples**

	Total number of firms		Initial positive rating		No initial positive rating		Firms never rated	
	Count	%	Count	%	Count	%	Count	%
Full sample:	458	100	56	12	297	65	105	23
Split samples:								
Charitable community	60	13	10	2	38	8	12	3
Non-charitable community	398	87	46	10	259	57	93	20
High consumer orientation	243	53	37	8	156	34	50	11
Low consumer orientation	215	47	19	4	141	31	55	12
Socially contested industry	63	14	10	2	53	12	0	0
Non-socially contested industry	395	86	46	10	244	53	105	23
High-performance firm	213	47	19	4	150	33	44	10
Low-performance firm	245	53	37	8	147	32	61	13

**Table 2. Community composition**

CBSA Code	CBSA Name	Number of firms
35620	New York-Northern New Jersey-Long Island, NY-NJ-PA MSA	56
16980	Chicago-Joliet-Naperville, IL-IN-WI MSA	40
14460	Boston-Cambridge-Quincy, MA-NH MSA	18
37980	Philadelphia-Camden-Wilmington, PA-NJ-DE-MD MSA	18
31100	Los Angeles-Long Beach-Santa Ana, CA MSA	17
33460	<b>Minneapolis-St. Paul-Bloomington, MN-WI MSA</b>	17
41180	St. Louis, MO-IL MSA	15
19100	Dallas-Fort Worth-Arlington, TX MSA	12
19820	Detroit-Warren-Livonia, MI MSA	12
40060	Richmond, VA MSA	11
41860	<b>San Francisco-Oakland-Fremont, CA MSA</b>	11
12060	Atlanta-Sandy Springs-Marietta, GA MSA	10
14860	Bridgeport-Stamford-Norwalk, CT MSA	10
47900	Washington-Arlington-Alexandria, DC-VA-MD-WV MSA	10
17460	Cleveland-Elyria-Mentor, OH MSA	9
38300	Pittsburgh, PA MSA	9
41940	San Jose-Sunnyvale-Santa Clara, CA MSA	8
26420	Houston-Sugar Land-Baytown, TX MSA	7
42660	<b>Seattle-Tacoma-Bellevue, WA MSA</b>	7
16740	Charlotte-Gastonia-Rock Hill, NC-SC MSA	6
25540	Hartford-West Hartford-East Hartford, CT MSA	6
33340	Milwaukee-Waukesha-West Allis, WI MSA	6
38900	Portland-Vancouver-Hillsboro, OR-WA MSA	6
12580	<b>Baltimore-Towson, MD MSA</b>	5
17140	Cincinnati-Middletown, OH-KY-IN MSA	5
19740	<b>Denver-Aurora-Broomfield, CO MSA</b>	4
28140	<b>Kansas City, MO-KS MSA</b>	4
38060	<b>Phoenix-Mesa-Glendale, AZ MSA</b>	4
Various	<b>Other metropolitan charitable communities</b>	8
	Other metropolitan communities	105
	Foreign-owned firms operating in the US	2
	<b>Total</b>	<b>458</b>

Charitable communities are highlighted in bold. Other charitable communities (with number of firms in parentheses) include Birmingham, AL (2), Jacksonville, FL (2), Norfolk, VA (1), and Rochester, NY (3).

**Table 3. Industry composition**

SIC code	Description	Number of firms
49	Electric, Gas, & Sanitary Services	49
28	Chemicals and Allied Products	46
60	Depository Institutions	43
20	Food and Kindred Products	27
35	Industrial and Commercial Machinery and Computer Equipment	24
37	Transportation Equipment	24
48	Communications	20
63	Insurance Carriers	17
26	Paper and Allied Products	17
36	Electronic and Other Electrical Equipment and Components	16
38	Measuring, Analyzing, and Controlling Instruments	16
27	Printing, Publishing, and Allied Industries	15
33	Primary Metal Industries	12
13	Oil and Gas Extraction	11
73	Business Services	11
29	Petroleum Refining and Related Industries	10
	Other Industries	100
	Total	458

**Table 4. Descriptive statistics**

	Mean	SD	Min	Max	1	2	3	4	5	6	7	8	9	10	11
1. Philanthropic contributions	0.99	0.97	0	9.52											
2. KLD rated X initial positive rating	0.06	0.24	0	1	0.13										
3. KLD rated X no initial positive rating	0.32	0.47	0	1	-0.08	-0.18									
4. Charitable community	0.13	0.34	0	1	0.10	0.04	0.00								
5. High consumer orientation	0.53	0.50	0	1	0.01	0.07	0.00	0.01							
6. Socially contested industry	0.14	0.35	0	1	0.01	0.03	0.08	-0.04	-0.14						
7. High-performance firm	0.47	0.50	0	1	-0.18	-0.06	0.05	0.07	0.02	-0.06					
8. Employees (log)	2.90	1.10	0.42	6.65	0.06	0.10	0.13	-0.01	0.11	0.29	-0.12				
9. Revenue (log)	8.01	1.17	4.68	11.82	0.01	0.07	0.19	-0.01	0.07	0.26	-0.15	0.85			
10. Assets (log)	8.34	1.48	4.92	12.44	-0.04	0.04	0.15	0.01	0.13	0.19	-0.14	0.57	0.79		
11. Foundation assets (log)	1.19	1.19	0	5.59	0.05	0.07	0.05	0.02	0.13	0.03	0.01	0.37	0.28	0.37	
12. Return on assets (ROA)	4.98	5.68	-43.02	52.24	-0.12	-0.01	-0.07	0.05	0.10	-0.05	0.43	-0.07	-0.33	-0.15	0.04

Note. 2,637 firm-year observations.

## Descriptive Results

I first examine the raw data to look for evidence of whether firms' philanthropic donations change after being rated. I find that firms initially recognized as a charitable organization gave on average 1.97 percent in the pre-rating period and 1.50 in the post-rating period. This drop of 0.47 percentage points stands in contrast to the change experienced by firms not initially recognized for their giving, for which the level of giving increased only slightly from 0.85 percent to 0.88 percent. This is both a statistically significant as well as a substantive difference in trends.<sup>31</sup>

## Model Specification

I tested the models using a difference-in-differences approach to compare firms' charitable contributions before and after being rated, and used as a reference group those that were not rated. I tested Hypothesis 1 by estimating the following model:<sup>32</sup>

$$Y_{it} = \beta_1 KLD\ rated_{it} \times initial\ positive\ rating_i + \beta_2 KLD\ rated_{it} \times no\ initial\ positive\ rating_i + \beta_3 X_{it} + \beta_4 \gamma_t + \alpha_i + e_{it}$$

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<sup>31</sup> To determine whether the difference in trends was statistically significant, I used OLS pooled regression (with robust standard errors clustered by firm) to estimate the following model:  $y = \beta_1 P_i + \beta_2 NP_i + \beta_3 (P_i \times R_{it}) + \beta_4 (NP_i \times R_{it})$  where  $y$  = total contributions as a percentage of pre-tax profits,  $P_i$  is a firm-level dummy coded '1' for firms that initially received a positive rating,  $NP_i$  is a firm-level dummy coded '1' for firms that were rated but did not receive a positive rating, and  $R_{it}$  is a dummy coded '1' for years in which a firm was rated by KLD. The statistical difference of the difference in trends was determined using a Wald test of the equality  $\beta_3 = \beta_4$ , which yielded  $F = 20.79$ ,  $p < .001$ .

<sup>32</sup> Following Chatterji & Toffel (2010), I included two interaction terms in my model to facilitate interpretation of the regression coefficients. The coefficient on the first interaction term directly tests Hypothesis 1. An alternative way of testing the hypothesis would be to include the main effect (KLD rated) with one of the interaction terms (e.g. KLD rated X positive rating). In this instance, however, the two OLS coefficients must be added together to determine whether the social performance effect of positive ratings differed from that of the unrated firms.

$Y_{it}$  refers to the charitable contributions of firm  $i$  in year  $t$ ,  $X_{it}$  is a vector of control variables,  $\alpha_i$  is a series of firm-fixed effects, and  $\gamma_{it}$  is a series of year dummies. I used clustered standard errors to correct for heteroskedasticity and autocorrelation.

To test the moderating effects described in Hypotheses 2 and 5, I estimated the model shown above with all variables interacted with two dummy variables. For example, the model that tests Hypotheses 2 interacts all variables with *charitable community* and *non-charitable community*. All models tested for significant differences between firms initially recognized for their charitable contributions, those rated but not recognized, and those not rated. These interactions not only allowed for comparisons between subcategories, but also within subcategories.<sup>33</sup>

## Results

### Main Results

I used STATA to test my models, employing ordinary least squares (OLS) regression with firm-level fixed effects. The efficacy of this research design depended on the assumption that the philanthropic contributions of each group of newly rated firms would have followed the trend of the unrated firms had KLD not issued their ratings. While not directly testable, this assumption would be strengthened if giving trends of all groups were found to be similar during the pre-rating period. To test this assumption, I compared trends from 1989–1990 across the three groups. Using T-tests, I found that differences in the percent change from 1989–1990 in philanthropic contributions were statistically insignificant across the three groups—those initially rated and recognized, those rated but not initially recognized, and those never rated.

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<sup>33</sup> While the interaction models are identical to running separate regressions on split samples, interacting both dummy variables (e.g. charitable and non-charitable community) with all other variables facilitates the comparison of coefficients.

**Table 5. Firm response after initial KLD rating**

	1	2
(A) KLD rated X initial positive rating	-0.448 *** (0.096)	-0.467 *** (0.123)
(B) KLD rated X no initial positive rating	0.012 (0.035)	-0.006 (0.079)
Employees (log)	-0.025 (0.148)	0.027 (0.170)
Sales (log)	-0.182 (0.144)	-0.293 * (0.161)
Assets (log)	0.211 * (0.126)	0.212 (0.134)
Foundation assets (log)	0.086 *** (0.033)	0.089 *** (0.032)
Return on assets (ROA)	-0.012 ** (0.005)	-0.009 (0.006)
Year Fixed Effects	No	Yes
Firm Fixed Effects	Yes	Yes
Observations	2,637	2,637
Firms	458	458
R-squared (within)	0.03	0.05
Wald test: coefficient (A) = (B) ?	19.95 ***	19.93 ***

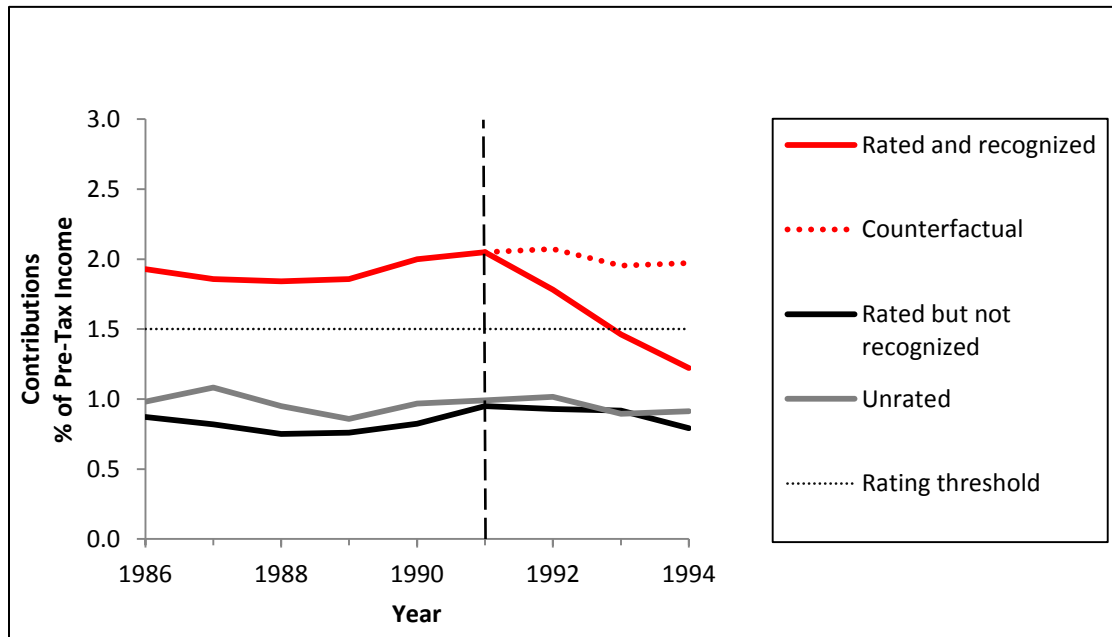
OLS regression coefficients with standard errors in brackets. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ . Wald test displays F test statistic where the null hypothesis is that the coefficients are statistically indistinguishable. The sample includes newly rated firms and never-rated firms.

Table 5 presents the results of the models that test Hypothesis 1. In the first model, I omit year dummies to estimate the *absolute* change in contributions between the pre- and post-rating periods. The negative coefficient for *KLD rated x initial positive rating* indicates that firms recognized for their charitable giving decreased their charitable contributions after being rated.<sup>34</sup> Nevertheless, because this model omitted year dummies, these *absolute* differences fail to account for changes in charitable contributions experienced by the control group of firms that were never rated. Thus to account for temporal changes in social norms and policy that affect all

<sup>34</sup> A Wald test indicates that contributions increased significantly more for firms not recognized for giving compared to those that were recognized ( $F = 19.95$ ,  $p < 0.01$ ).



firms in the sample, I include year dummies in the second model. The results of this model indicate that firms initially recognized for their charitable contributions reduced their charitable contributions by 0.47 percentage points less than firms never rated ( $\beta = -0.467$ ,  $p < 0.01$ ), a magnitude equal to approximately one-half of one-standard deviation (calculated as  $\beta = -0.467$  divided by the standard deviation of philanthropic contributions = 0.97). A Wald test comparing the coefficients of the two interaction terms revealed that firms initially rated superior reduced their contributions more than firms that were rated but not recognized for the charitable giving ( $F = 19.93$ ,  $p < 0.01$ ). Overall, these results strongly support Hypothesis 1 (see Figure 1).

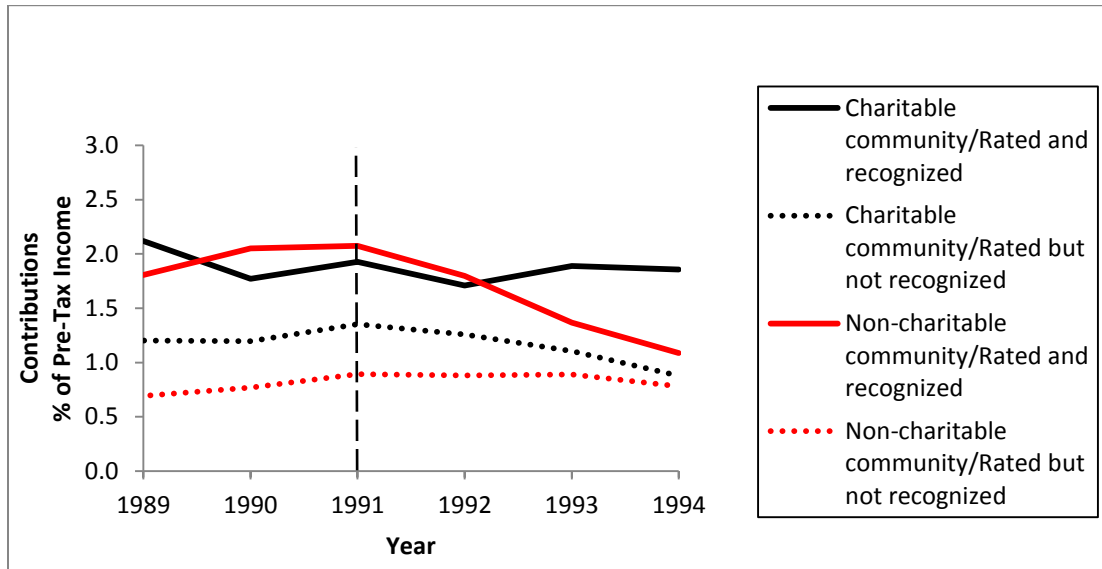


**Figure 1. Trends in charitable contributions.**

**Table 6. Firm response moderated by charitable community**

	1	2
(A) Charitable community X KLD rated X initial positive rating	-0.124 (0.137)	-0.124 (0.150)
(B) Charitable community X KLD rated X no initial positive rating	-0.100 (0.062)	-0.115 (0.094)
Charitable community X Employees (log)	-0.178 (0.361)	-0.074 (0.378)
Charitable community X Sales (log)	-0.289 (0.376)	-0.473 (0.378)
Charitable community X Assets (log)	0.526 * (0.268)	0.537 ** (0.259)
Charitable community X Foundation assets (log)	0.021 (0.104)	0.024 (0.104)
Charitable community X Return on assets	0.023 (0.017)	0.024 (0.017)
(C) Non-charitable community X KLD rated X initial positive rating	-0.519 *** (0.110)	-0.541 *** (0.135)
(D) Non-charitable community X KLD rated X no initial positive rating	0.029 (0.038)	0.010 (0.081)
Non-charitable community X Employees (log)	0.031 (0.135)	0.077 (0.159)
Non-charitable community X Sales (log)	-0.173 (0.151)	-0.275 * (0.166)
Non-charitable community X Assets (log)	0.145 (0.132)	0.142 (0.140)
Non-charitable community X Foundation assets (log)	0.093 *** (0.033)	0.097 *** (0.032)
Non-charitable community X Return on assets	-0.014 ** (0.006)	-0.012 ** (0.006)
Year Fixed Effects	No	Yes
Firm Fixed Effects	Yes	Yes
Observations	2,637	2,637
Firms	458	458
R-squared (within)	0.04	0.06
Wald test: coefficient (A) = (B)?	0.03	0.00
Wald test: coefficient (C) = (D)?	21.75 ***	21.78 ***
Wald test: coefficient (A) - (B) = (C) - (D)?	3.40 *	8.32 ***

OLS regression coefficients with standard errors in brackets. \*\*\* p<0.01, \*\* p<0.05, \* p<0.10. Wald test displays F test statistic where the null hypothesis is that the coefficients are statistically indistinguishable. The sample includes newly rated firms and never-rated firms.



**Figure 2. Trends in contributions by charitable community.**

Table 6 presents the results of the fully interacted model that tests Hypothesis 2. Again, Column 1 reports results of a model that excludes year dummies. These results indicate that only firms that were not recognized for charitable giving and that were members of a charitable community experienced absolute increases in their contributions from the pre- to post-rating period. The second model, which includes year dummies, accounts for the control group's temporal trends. Here the negative statistically significant coefficient on *Non-charitable community x KLD rated x initial positive rating* indicates that firms in non-charitable communities that were recognized for their giving practices reduced their contributions by 0.54 percentage points ( $p < 0.01$ ), about one-half of one standard deviation (calculated as  $\beta = -0.54/SD = 0.97$ ) more than did firms in the control group (of firms in charitable communities that were never rated). A Wald test comparing the coefficients of the first and second interaction term revealed that firms in non-charitable communities that were initially rated superior also reduced their contributions to a greater extent than firms in non-charitable communities that were not recognized for their giving (Wald test  $F = 21.78$ ,

$p < 0.01$ ). The insignificance on the first and second interaction terms indicates that the effect of an initial positive rating on a firm's philanthropic contributions is only present in non-charitable communities. Overall, the results presented in Table 5 support Hypothesis 2 (see Figure 2) by indicating that among firms in non-charitable communities, those that receive a superior rating will decrease their contributions to a greater extent than other firms.

The results testing Hypothesis 3 are displayed in Table 7. In column 1, we see that both firms with either a high (*High consumer orientation x KLD rated x initial positive rating*) or low consumer orientation (*Low consumer orientation x KLD rated x initial positive rating*) decreased their contributions following positive recognition. These findings continue to hold even when controlling for the trends of the unrated firms (column 2). Comparing the two coefficients using a Wald test revealed that neither high (A-B) or low consumer oriented firms (C-D) were more likely to reduce their contributions following positive recognition. Thus I find no evidence in support of Hypothesis 3 (see Figure 3).

Table 8 presents the results for Hypothesis 4. Both models provide evidence that firms operating in non-socially contested industries were more likely to reduce their contributions following positive recognition. In Model 2, The statistically negative coefficient on *Non-socially contested industry x KLD rated x initial positive rating* indicates that firms operating in non-socially contested industries that were recognized for their giving practices reduced their contributions by 0.54 percentage points ( $p < 0.01$ ), about one-half of one standard deviation (calculated as  $\beta = -0.54/SD = 0.97$ ) more than did firms in the control group (of firms in non-socially contested industries that were never rated). A Wald test comparing the coefficients C and D revealed that firms in non-socially contested industries that were initially rated positive also reduced their contributions to a greater extent than firms in non-socially

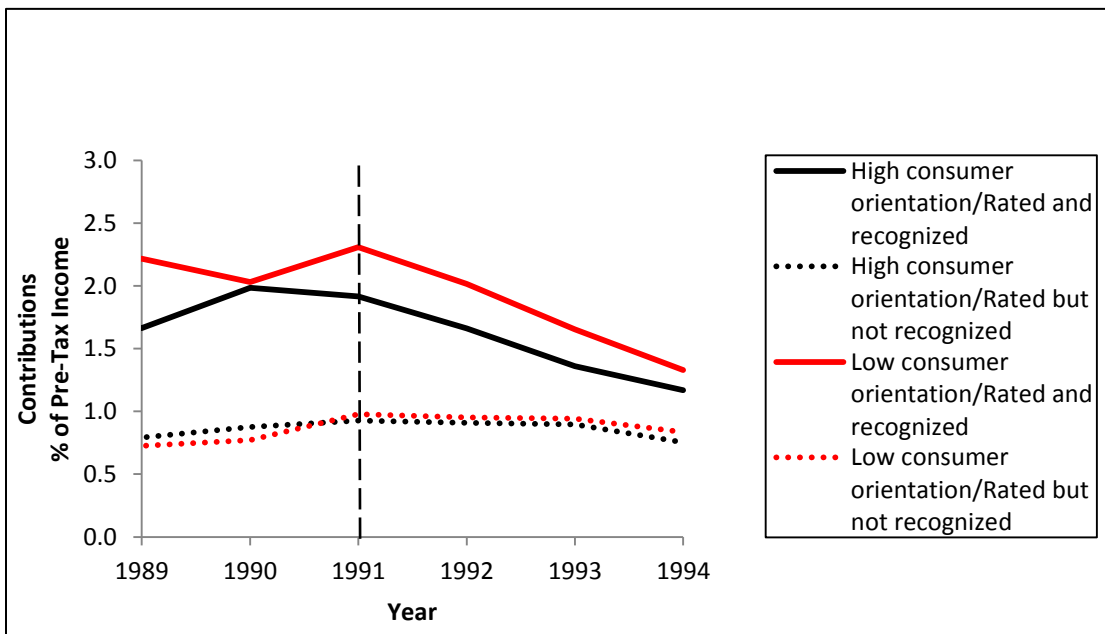
contested industries that were not recognized for their giving ( $F = 23.13, p < 0.01$ ). No significant differences were found among firms operating in socially contested industries (comparison of coefficients A and B). Overall, the results presented in Table 8 support Hypothesis 3 (see Figure 4) by indicating that among firms in non-socially contested industries, those that receive a positive rating decrease their contributions to a greater extent than other firms.

Finally the results testing Hypothesis 5 are displayed in Table 9. Again, the first model suggests that firms with low financial performance that were given a positive rating decreased their absolute contributions from the pre- to the post-rated period. The full model indicates that among firms with low performance, those that were initially recognized for their generous giving reduced their contributions by 0.62 percentage points more than firms that were never rated, a difference of just under two-thirds of one standard deviation (calculated as  $\beta = -0.62/SD = 0.97$ ). A Wald test reveals that among firms with low performance, those recognized for their generous giving reduced their contributions to a greater extent than firms with low performance that were not recognized (Wald test  $F = 19.79, p < 0.01$ ). Furthermore, the difference between coefficients A and B was statistically indistinguishable thus providing no evidence that managers of firms with high financial performance were more likely to reduce their subsequent contributions. The results of Table 9 thus support Hypothesis 5 (see Figure 5), as they indicate that positive ratings are associated with reductions in charitable giving, especially for firms with low financial performance.

**Table 7. Firm response moderated by consumer orientation**

	1	2
(A) High consumer orientation X KLD rated X initial positive rating	-0.450 *** (0.105)	-0.475 *** (0.128)
(B) High consumer orientation X KLD rated X no initial positive rating	-0.065 * (0.039)	-0.087 (0.082)
High consumer orientation X Employees (log)	-0.046 (0.178)	0.067 (0.186)
High consumer orientation X Sales (log)	0.304 ** (0.139)	0.179 (0.144)
High consumer orientation X Assets (log)	-0.044 (0.134)	-0.076 (0.139)
High consumer orientation X Foundation assets (log)	0.103 ** (0.045)	0.116 ** (0.045)
High consumer orientation X Return on assets	-0.019 ** (0.009)	-0.017 * (0.009)
(C) Low consumer orientation X KLD rated X initial positive rating	-0.459 ** (0.199)	-0.497 ** (0.218)
(D) Low consumer orientation X KLD rated X no initial positive rating	0.106 * (0.057)	0.075 (0.090)
Low consumer orientation X Employees (log)	0.138 (0.224)	0.149 (0.253)
Low consumer orientation X Sales (log)	-0.831 *** (0.262)	-0.928 *** (0.276)
Low consumer orientation X Assets (log)	0.481 ** (0.221)	0.489 ** (0.223)
Low consumer orientation X Foundation assets (log)	0.08 * (0.048)	0.069 (0.047)
Low consumer orientation X Return on assets	-0.004 (0.006)	-0.001 (0.006)
Year Fixed Effects	No	Yes
Firm Fixed Effects	Yes	Yes
Observations	2,637	2,637
Firms	458	458
R-squared (within)	0.05	0.07
Wald test: coefficient (A) = (B)?	13.01 ***	13.05 ***
Wald test: coefficient (C) = (D)?	6.94 ***	7.06 ***
Wald test: coefficient (A) - (B) = (C) - (D)?	0.57	0.58

OLS regression coefficients with standard errors in brackets. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ . Wald test displays F test statistic where the null hypothesis is that the coefficients are statistically indistinguishable. The sample includes newly rated firms and never-rated firms.



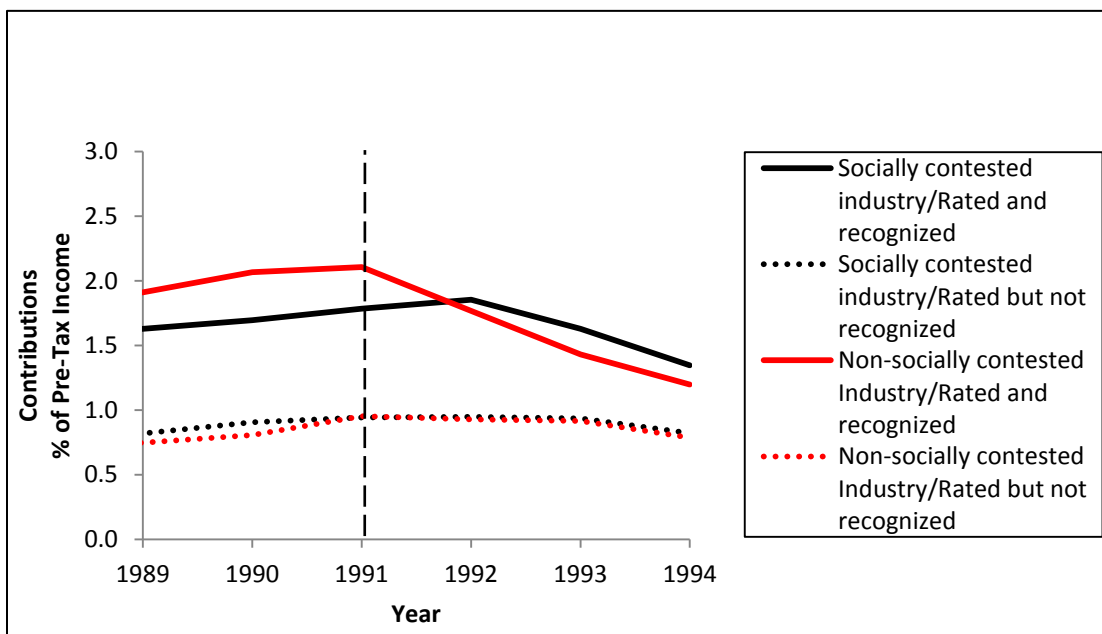
**Figure 3. Trends in contributions by consumer orientation.**

**Table 8. Firm response moderated by socially contested industry**

	1	2
(A) Socially contested industry X KLD rated X initial positive rating	0.094 (0.214)	0.093 (0.230)
(B) Socially contested industry X KLD rated X no initial positive rating	0.107 (0.105)	0.097 (0.133)
Socially contested industry X Employees (log)	0.574 (0.648)	0.607 (0.663)
Socially contested industry X Sales (log)	-0.911 * (0.501)	-1.141 ** (0.525)
Socially contested industry X Assets (log)	0.038 (0.354)	0.100 (0.354)
Socially contested industry X Foundation assets (log)	-0.003 (0.075)	0.032 (0.071)
Socially contested industry X Return on assets	-0.016 (0.013)	-0.012 (0.013)
(C) Non-socially contested industry X KLD rated X initial positive rating	-0.532 *** (0.105)	-0.543 *** (0.130)
(D) Non-socially contested industry X KLD rated X no initial positive rating	0.008 (0.037)	0.000 (0.080)
Non-socially contested industry X Employees (log)	-0.057 (0.150)	0.007 (0.171)
Non-socially contested industry X Sales (log)	-0.146 (0.148)	-0.255 (0.163)
Non-socially contested industry X Assets (log)	0.237 * (0.133)	0.225 (0.138)
Non-socially contested industry X Foundation assets (log)	0.102 *** (0.036)	0.100 *** (0.036)
Non-socially contested industry X Return on assets	-0.011 * (0.006)	-0.008 (0.006)
Year Fixed Effects	No	Yes
Firm Fixed Effects	Yes	Yes
Observations	2,637	2,637
Firms	458	458
R-squared (within)	0.04	0.06
Wald test: coefficient (A) = (B)?	0.00	0.00
Wald test: coefficient (C) = (D)?	23.12 ***	23.13 ***
Wald test: coefficient (A) - (B) = (C) - (D)?	4.62 **	4.77 **

OLS regression coefficients with standard errors in brackets. \*\*\* p<0.01, \*\* p<0.05, \* p<0.10. Wald test displays F test statistic where the null hypothesis is that the coefficients are statistically indistinguishable. The sample includes newly rated firms and never-rated firms.



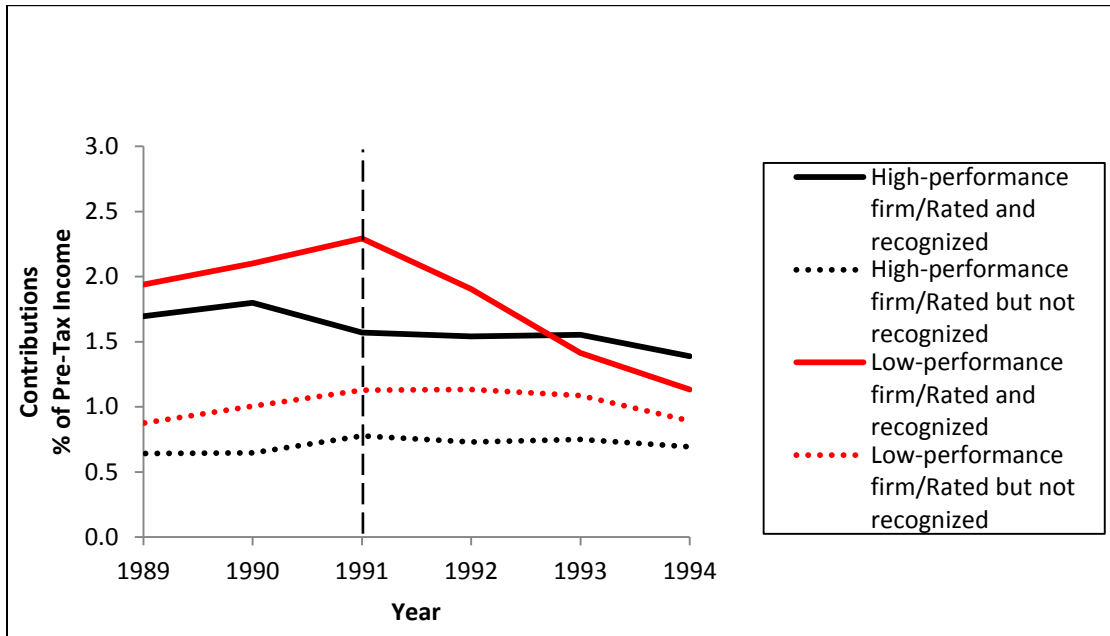


**Figure 4. Trends in contributions by socially contested industry.**

**Table 9. Firm response moderated by prior financial performance**

	1	2
High-performance firm X KLD rated X initial positive rating	-0.179 (0.167)	-0.195 (0.182)
High-performance firm X KLD rated X no initial positive rating	0.058 (0.037)	0.038 (0.079)
High-performance firm X Employees (log)	0.056 (0.239)	0.113 (0.248)
High-performance firm X Sales (log)	-0.161 (0.150)	-0.303 * (0.161)
High-performance firm X Assets (log)	0.078 (0.154)	0.096 (0.173)
High-performance firm X Foundation assets (log)	0.039 (0.039)	0.044 (0.038)
High-performance firm X Return on assets	0.001 (0.007)	0.003 (0.007)
Low-performance firm X KLD rated X initial positive rating	-0.594 *** (0.111)	-0.621 *** (0.137)
Low-performance firm X KLD rated X no initial positive rating	-0.037 (0.057)	-0.061 (0.094)
Low-performance firm X Employees (log)	-0.089 (0.187)	-0.032 (0.205)
Low-performance firm X Sales (log)	-0.252 (0.207)	-0.353 (0.223)
Low-performance firm X Assets (log)	0.346 * (0.184)	0.323 * (0.181)
Low-performance firm X Foundation assets (log)	0.108 ** (0.048)	0.110 ** (0.048)
Low-performance firm X Return on assets	-0.02 *** (0.007)	-0.016 ** (0.007)
Year Fixed Effects	No	Yes
Firm Fixed Effects	Yes	Yes
Observations	2,637	2,637
Firms	458	458
R-squared (within)	0.04	0.06
Wald test: coefficient (A) = (B)?	1.76	1.72
Wald test: coefficient (C) = (D)?	19.88 ***	19.79 ***
Wald test: coefficient (A) - (B) = (C) - (D)?	2.16	2.23

OLS regression coefficients with standard errors in brackets. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.10$ . Wald test displays F test statistic where the null hypothesis is that the coefficients are statistically indistinguishable. The sample includes newly rated firms and never-rated firms.



**Figure 5. Trends in contributions by prior financial performance.**

### Robustness Tests

Although the findings are broadly consistent with my main theoretical arguments, there are indeed alternative explanations. Most threatening is the concern that the observed reduction in contributions for recognized firms may simply be due to regression to the mean. This argument is particularly relevant if we assume the possibility that contributions may drop for purely stochastic rather than behavioral reasons (Bothner, Kim, & Smith, 2012).<sup>35</sup> To thus rule out the possibility of mean reversion, I estimated a dynamic model that included a lagged dependent variable to control for prior levels of giving. Using a lagged dependent variable with firm fixed-effects can be problematic, however, as error term will almost certainly be correlated with the lagged-dependent variable which can lead to inconsistent estimates (Angrist & Pischke, 2009; Wade, Porac, Pollock, & Graffin, 2006). To overcome this problem,

<sup>35</sup> For example, it could very well be that firms randomly gave at higher levels in the years preceding the rating and were consequently recognized as a charitable organization by KLD. If this were indeed the case, subsequent reductions could be considered random fluctuations rather than actual responses.

I used a model developed by Arellano and Bond (1991), which relies on lagged values of the dependent variable to act as instruments for changes in contributions. Results using this alternative specification were still consistent with the findings from the main analysis, thus providing robust support for Hypothesis 1.

Another way to rule out mean reversion would be to run a falsification test during the pre-treatment period. Such a test would entail assigning each firm a false year in which the rating period began and re-estimating the main difference-in-differences model during the years 1986 to 1991. To carry out this evaluation, I thus assumed that the ratings that were ultimately given by KLD in 1991, were actually assigned in the year 1988. The results for this alternative specification revealed that over this time period, firms that ultimately received a positive rating maintained similar trends in the corporate contributions when compared to the control group of firms (unrated) and the firms that were ultimately rated but not recognized.<sup>36</sup> Viewing these results alongside the main results, I thus conclude that firms that ultimately received a positive rating by KLD maintained consistently high levels of giving during the pre-rating period, and then responded to the rating in 1991 by reducing their subsequent contributions (see Figure 1). Combined with the earlier results that controlled for prior levels of giving, these findings thus lead me to believe that my results are not being driven by mean reversion.

I also performed robustness tests to evaluate the extent to which my results were sensitive to alternative measures of the dependent variable. First, I considered an alternative measure of charitable giving. Although contributions as a percentage of pre-tax profits has historically been the most commonly used measure within the corporate community when establishing annual contributions budgets (Lydenberg et

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<sup>36</sup> If the findings in my main analysis were indeed driven by random fluctuations, I would have likely found similar reductions in the pre-rating period. Such findings would cast doubt on my main argument that subsequent reductions following recognition were an actual response to the ratings.

al., 1986), recent surveys suggest that changes in giving may be better connected with changes in revenue, not changes in pre-tax profit, as is generally assumed (Coady, 2009). Thus one alternative measure of corporate philanthropy could be the total amount of philanthropic contributions scaled by revenue rather than pre-tax profits. Another commonly used measure within the literature is the total amount of philanthropic contributions (Atkinson & Galaskiewicz, 1988; Galaskiewicz, 1985, 1997; Galaskiewicz & Burt, 1991; Galaskiewicz & Wasserman, 1989; Marquis & Lee, 2013; Tilsik & Marquis, 2013).<sup>37</sup> To thus test the sensitivity of the results to these various measures of corporate giving, I reran the main-effects model shown in Table 5 using the total philanthropic contributions scaled by revenue and the total philanthropic contributions (logged). Results using both alternative measures were not substantively different than those obtained in the main analysis.

### **Summary**

In summary, I found strong support for my primary hypothesis that recognition as a charitable organization could lead exceptionally generous firms to reduce their subsequent contributions more than other firms. As shown in Table 10, firms that were rated and recognized as a charitable organization, on average, decreased their subsequent contributions by 0.47 percentage points from 1.97 to 1.50. No substantive change was found for firms that were rated but not recognized by KLD.

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<sup>37</sup> This measure is generally transformed using a log-transformation to reduce the influence of outliers.

**Table 10. Pre- and post-rating trends for rated and recognized firms**

	Pre-rating contributions (1989–1991)	Post-rating contributions (1992–1994)	Number of firms
Firms rated by KLD:			
KLD rated X initial positive rating	1.97	1.50	56
KLD rated X no initial positive rating	0.85	0.88	297
Firms rated and recognized by KLD:			
Charitable community	1.93	1.82	10
Non-charitable community	1.98	1.43	46
High consumer orientation	1.86	1.40	37
Low consumer orientation	2.19	1.68	19
Socially contested industry	1.70	1.62	10
Non-socially contested industry	2.03	1.47	46
High-performance firm	1.69	1.50	19
Low-performance firm	2.11	1.50	37

I also found strong support for most of the hypothesized moderating effects. Firms headquartered in charitable communities, such as Boeing (headquartered in Seattle) and Honeywell (headquartered in Minneapolis), were much less likely to decrease their contributions following positive recognition, presumably because these firms face substantial normative pressures to maintain high levels of philanthropic giving. Firms operating in socially contested sectors, such as Seagram (alcohol) and UST (tobacco), were also less likely to decrease their contributions following positive recognition, seemingly because the inherent reputational risks associated with their business activities require higher levels of “insurance-like” protection afforded by charitable contributions.

Finally, recognition as a charitable organization did not appear to substantively influence subsequent contributions for firms whose past financial performance was

high, presumably because past financial success leads to strategic persistence. For firms whose past financial performance was low, however, such recognition likely triggered sequential attention mechanisms, which led such firms to refocus their attention and resources towards firm profitability goals, and thus reduce their subsequent contributions.

Contrary to my prediction, I found no evidence for a moderating effect of consumer orientation on firm response to being rated as a charitable organization. Although somewhat surprising, this lack of evidence is consistent with Galaskiewicz's (1985, 1997) previous finding that dependence on consumer sales is not a consistent predictor of philanthropic behaviors. One explanation for this lack of support may be due to the measure itself rather than the underlying theory. Indeed, this hypothesis was originally motivated by the assertion that reputation-sensitive firms would be more concerned about the perceived loss of reputation associated with reductions in contributions. In this study, however, reputational sensitivity was operationalized using a coarse-grained industry classification, rather than a firm's individual reputation. Given this disconnect between theory and data, it could very well be that positive results could be obtained by using data that more directly assessed reputational sensitivity at the firm rather than industry level.

## CHAPTER 6: DISCUSSION AND CONCLUSION

In this dissertation, I have argued that positive ratings could ironically lead firms to reduce their subsequent performance. Drawing upon the tenets of behavioral theory and performance feedback theory (Argote & Greve, 2007; Cyert & March, 1963; Gavetti et al., 2012; Greve, 2003b), I proposed that positive ratings could lead firms whose prior performance exceeds the threshold to perceive the new performance standard as a satisfactory and acceptable goal. Such changes in perceptions could lead high-performing firms to redefine their aspirations and thus reduce their subsequent performance.

I tested this premise by examining how being rated as a charitable organization influenced a firm's subsequent level of philanthropic contributions. I found that firms that met the performance threshold established by the rating agency were more likely to decrease their subsequent contributions than other firms. Such reductions, however, were less likely to occur for firms located in communities with strong normative pressures that favor corporate involvement in the community as well as for firms with higher levels of industry-specific risk, such as those operating in socially contested industries. I also found that subsequent reductions were particularly likely among firms whose prior financial performance was below their peers.

Together, these findings extend scholarly work by redefining our understanding about the performance effects of positive ratings and by theoretically expanding the ways in which organizational aspirations are formed. For scholars and practitioners interested in corporate responsibility, these findings also demonstrate that there are certain risks associated with recognizing responsibility; that efforts to promote increased social performance can paradoxically lead to reductions in social performance.



## **Firm Response to Positive Ratings**

The primary contribution of this study speaks to a recent body of literature that examines the impact of ratings on rated organizations (Chatterji & Toffel, 2010; Elsbach & Kramer, 1996; Espeland & Sauder, 2007; Jin & Leslie, 2003; Martins, 2005). A common theme among these studies is poorly rated firms tend to improve. In this study, I extend this growing body of research by examining the performance effects of positive ratings. Contrary to conventional wisdom, I find that positive ratings that recognize firms for their past performance can ironically lead these same firms to reduce their subsequent performance. This finding is important from a theoretical and practical perspective as both organizational scholars and practitioners have implicitly assumed that the use of positive recognition as a reward is indeed an effective way to drive improvements in subsequent behavior and performance (Fombrun, 1996; Sadowski et al., 2010; Waddock et al., 2000).

My findings also contribute to the literature on the performance effects of ratings by demonstrating that firm response to positive recognition can be moderated by institutional and organizational characteristics. Indeed, previous work has established that regulatory environments and firms' efficiency levels can moderate firm response to ratings (Chatterji & Toffel, 2010). I extend this literature by examining how other contingency factors, including local communities (Marquis & Battilana, 2009; Marquis et al., 2007), industry-specific risk (Brammer & Pavelin, 2005; Godfrey, 2005; Koh et al., 2013), and prior financial performance, moderate firm response. Such factors are of theoretical value because they help scholars to better understand how and when positive ratings will lead to reductions in performance.

### **Ratings as Source of Performance Feedback**

This study also contributes to the behavioral and performance feedback literature by theoretically expanding the ways in which aspiration levels are formed. Extant research suggests that aspiration levels are typically based on the firm's historical performance and the performance of similar others (Argote & Greve, 2007; Cyert & March, 1963; Greve, 1998). While scholars have certainly acknowledged that third-party ratings can *indirectly* alter aspirations by providing information that facilitates social comparison (Greve, 2003b), limited attention has been paid to the *direct* feedback that institutional elements, such as ratings, provide (Gavetti et al., 2012; Gavetti et al., 2007; Shinkle, 2012). In this study, I thus extend behavioral theory by proposing that ratings can serve as a direct source of performance feedback to which firms respond. By redefining standards of appropriate and acceptable behavior, such ratings can lead high-performing firms to lower their aspirations and thus reduce their subsequent performance.

### **Limitations and Future Research**

While I am confident in the results of my study, I acknowledge a number of limitations and suggest some areas of future research. Central to my main argument was the assertion that positive ratings could lead firms to reduce their subsequent contributions by reducing uncertainty regarding the standards of appropriate and acceptable giving. Under the assumption that firms would seek to avoid uncertainty, I maintained that the introduction of a new performance standard could lead high-performing firms to perceive the standard as an acceptable and satisfactory goal and thus lead them to reduce their performance. While the results of this study are consistent with this argument, I was unable to test this mechanism directly as the process by which aspirations are formed and determined are largely unobservable in

large archival studies. Experimental methods using a similar context could therefore be used to test whether managerial aspirations are indeed influenced by positive ratings.

Although the main focus of the study was on the performance effects of positive ratings, I was also somewhat surprised to find that firms that were not recognized for giving showed little to no change in contributions relative to the control group. Because prior research has found that firms respond to negative ratings (Chatterji & Toffel, 2010), it would have been reasonable to expect that firms that were unrecognized might increase the level of their contributions in subsequent years. Such results would have been consistent with KLD's belief that the reputation and status associated with positive recognition would motivate the unrecognized firms to improve (see Appendix B).

On the other hand, there are at least three compelling reasons why firms with lower levels of charitable giving were unresponsive to the ratings. First, scholars have argued that corporate philanthropy (which is subsumed under the broader construct of corporate responsibility) is better understood as one dimension of corporate strategy and that firms will choose different levels of giving depending on the risk and opportunities they face (Vogel, 2005). Given this argument, it is therefore plausible that low-performing firms were unresponsive to the ratings simply because they did not view philanthropy as essential to the strategic purposes of their firm. The fact that these firms give at all might be better explained by institutional mechanisms such as decoupling or symbolic compliance (Meyer & Rowan, 1977; Oliver, 1991). Second, even if the unrecognized firms desired to increase their subsequent contributions, such increases could have been difficult to achieve in the short run due to the highly institutionalized nature of corporate giving (e.g. foundations, corporate giving programs, etc.). Finally, research on human perception suggests that there is

significant asymmetry between the cognitive processing of positive and negative events, with bad being much stronger than good (Baumeister, Bratslavsky, Finkenauer, & Vohs, 2001). For example, one might expect that being recognized as a selfish organization might generate a stronger response than being unrecognized as a charitable organization. Given these arguments, low-performing firms that were not recognized as a charitable organization might have been unresponsive simply because being unrecognized does not stimulate response to the same degree as being recognized for something that is negative or undesirable.

One of the primary assumptions of this paper is that most public corporations engage in philanthropy as a means to secure their reputation among their peers and community. Although this assumption may hold true for the majority, I grant that a number of firms may be motivated for more altruistic reasons, whether it be a sense of moral obligation and duty (Logsdon & Wood, 2002; Wood & Logsdon, 2002), or as part of their organizational identity (Albert & Whetten, 1985). Target, for example, has been giving 5 percent of its pretax profits to local communities since 1946. Firms like Target, which have strong philanthropic identities, may be less likely to satisfice after being rated as a charitable organization. Future research could thus extend these findings by examining how such identity and commitment moderate firm responses to positive ratings.

Because the hypotheses were tested in a very specific context, an important question to consider is whether performance reductions following positive recognition would be found in other empirical settings. As noted in Chapter 4, one particular important assertion in my main premise is that firms lack a general knowledge about the consequences of philanthropy, and that this lack of knowledge leads to substantial uncertainty regarding how much they should give. Such uncertainty, I argued, was a key factor in driving high-performing firms to reduce their subsequent contributions.

Following this logic, the presence of uncertainty in decision-making may therefore be a necessary condition for firms to reduce their subsequent performance following positive recognition. Future research could therefore extend this work by examining how firms respond to positive ratings in situations with less uncertainty.

Another important aspect of the empirical context was that the rating defined a specific performance threshold. Such specificity, I argued, was a driving factor in reducing uncertainty about how much firms should give. Not all ratings, however, define specific performance thresholds. In fact, some rating agencies may deliberately prefer ambiguous standards as it enables them to maintain power and control over the rating process (Graffin & Ward, 2010).<sup>38</sup> Because firms seek to avoid uncertainty by following decision rules (Cyert & March, 1963; Gavetti et al., 2012), it then follows that having a rating that defines a specific performance standard may also be a necessary condition for firms to reduce their subsequent performance following positive recognition. Future research could therefore extend this work by examining how firms respond to positive ratings that do not define specific performance standards.

### **The Paradox of Recognizing Responsibility**

Stakeholders interested in corporate responsibility have often used ratings as a means to increase transparency and reduce information asymmetry (Chatterji & Levine, 2006; Chatterji et al., 2009). Implied in this pursuit is the idea that recognizing good behavior can motivate corporations to maintain or increase their level of corporate responsibility. Nevertheless, because such ratings influence the decision-making

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<sup>38</sup> For example, Graffin and Ward noted that if standards “for being ‘green’ or ‘socially responsible’ were clear and quantifiable, such interest groups would quickly lose influence as meeting a particular standard would simply amount to checking off ‘green practices.’ As such, it may behoove such organizations to make sure that their standards remain uncertain” (2010, p. 343).

processes of managers, they do impose hidden risks. In this study, I show that efforts to promote corporate responsibility through recognition and rewards can paradoxically lead to reductions in social performance. Such findings are theoretically relevant because they provide some insight as to why we continue to see acts of corporate irresponsibility even as efforts to motivate socially responsible behavior increase.

From a policy perspective, these findings also suggest that there may be unintended consequences when rewarding responsibility. Ironically, efforts to promote responsible corporate behavior may prove to be unhelpful or even harmful. I do not mean to suggest that such efforts are useless, only that the potential negative effects need to be taken into consideration. While much more research is needed, given what we know about the efficacy of negative ratings, these findings suggest that policy makers and stakeholders who have an interest in motivating increased corporate responsibility may want to focus on singling out the poor performers rather than recognizing the good.

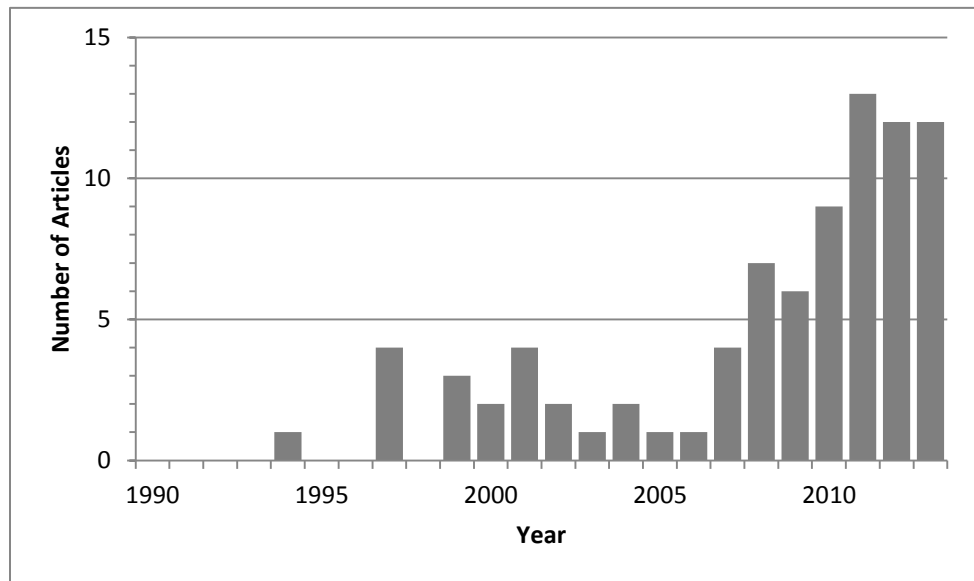
## **APPENDIX A: ACADEMIC STUDIES USING THE KLD RATINGS**

Widely used in the subfields of stakeholder management and corporate social responsibility (Berman, Wicks, Kotha, & Jones, 1999; Chatterji & Toffel, 2010; Margolis & Walsh, 2003), the KLD ratings have been utilized in number of academic articles. To systematically analyze the ways in which the ratings have been used, I undertook a review of all published empirical articles that have utilized the KLD ratings as a primary independent or dependent variable from 1991, when the ratings were first issued, to May 2013.

Specifically, I used the EBSCO database Business Source Complete and searched for peer-reviewed articles that referenced the KLD ratings in the following top journals: Academy of Management Journal (AMJ), Administrative Science Quarterly (ASQ), Organization Science (OS), and the Strategic Management Journal (SMJ). I also included two specialty journals, Business & Society (B&S) and Journal of Business Ethics (JBE), two management journals that have historically published articles on issues surrounding corporate social responsibility. Using the search term “KLD” or “Kinder Lydenberg Domini,” I found 218 articles that referenced the KLD ratings in the text. After reviewing each article, I then removed those that did not include the KLD ratings as an independent or dependent variable. Many of these articles only mentioned the dataset in passing reference. Others were theoretical articles that did not perform an empirical analysis. A handful of articles also sought to validate the KLD data with other types of CSR proxies, but did not explicitly use ratings to test hypotheses. Following this screening process, I obtained 84 empirical articles that directly utilized the KLD ratings in their analysis.

As shown in Figure A.1, the first article to use the KLD ratings was published in 1994, three years after the ratings were first issued. The number of articles

published per year using the KLD data, has risen slowly, but steadily over the years, with a maximum of 13 in 2011.<sup>39</sup> Also interesting to note, is the timing of publication by journals (see Table A.1). From 1994 to 2005, AMJ (25%) and B&S (50%) published the majority of articles using the KLD dataset, perhaps reflecting their prominence as some of the leading theoretical and specialty journals in the field respectively. Since 2005, however, the majority of articles using KLD data in their analysis have been published in SMJ (27%) and JBE (59%). While these shifts in publications trends for work using the KLD data could very well correspond with lower perceived prestige of the two journals, they could also be indicative of increased interest in the strategic and ethical implications of corporate social and environmental performance.



**Figure A.1. Academic articles using the KLD data.**

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<sup>39</sup> Although 2011 marks the high-water year for the publication of articles using the KLD dataset, 2013 will likely surpass this level as 12 articles have already been published in the first 5 months of the year.



**Table A.1. Distribution of articles by journal and time**

Journal	All ( <i>n</i> = 84)	1994–2005 ( <i>n</i> = 20)	2006–Present ( <i>n</i> = 64)
<i>Administrative Science Quarterly</i>	2%	0%	3%
<i>Academy of Management Journal</i>	7%	25%	2%
<i>Business &amp; Society</i>	19%	50%	9%
<i>Organization Science</i>	0%	0%	0%
<i>Strategic Management Journal</i>	24%	15%	27%
<i>Journal of Business Ethics</i>	48%	10%	59%

The articles differed on several dimensions, including the level at which the ratings were aggregated and whether ratings were used as an independent or dependent variable. As displayed in Table A.2, Panel A, approximately one-third of the articles simply summed the strength and concerns indicators to create a composite CSP or CSR index (Hillman & Keim, 2001). While some scholars have been critical of this approach (Godfrey et al., 2009; Mattingly & Berman, 2006), this type of aggregation is useful in that it allows researchers to easily compare overall CSP across a large number of firms. The remaining two-thirds have used the ratings in a disaggregated form, divided by strengths and concerns, by individual categories (e.g. environment, community, diversity, etc.), or by individual items. In contrast to aggregation, the disaggregation approach allows researchers to examine more nuanced questions regarding the antecedents and consequences of various dimensions CSP and the degree to which firms differentially attend to various stakeholder groups.

Of all the studies that have used the ratings as a primary explanatory variable (IV), more than half (53%) sought to determine the relationship between corporate social performance (whether broad or specific dimensions) and some measure of financial performance or risk (e.g. return on assets, revenue growth, Tobin's Q, abnormal returns, cost of capital, etc.) (see Table A.2, Panel B). Indeed, as noted by

Margolis and Walsh (2003, p. 273), such patterns “reflect the enduring quest to find a persuasive business case for social initiatives.” Other common outcomes of interest included ESG performance (e.g. release of toxic emissions, the likelihood of corporate donations, and executive compensation), corporate reputation (e.g. quality of management, attractiveness to employees, etc.), and the level and quality of disclosure.

**Table A.2. Variation in studies using the KLD ratings**

**Panel A. Article breakdown by variable status and level of aggregation**

Variable Status	Level of Aggregation	
	Aggregated	Disaggregated
Dependent Variable	10 (12%)*	21 (25%)
Independent Variable	18 (21%)	35 (42%)

\*Count (Percentage)

**Panel B. Studies using the KLD ratings as an independent variable**

Dependent Variable	Count	Percentage
Financial performance	28	53%
ESG Performance	11	21%
Reputation	6	11%
Disclosure	5	9%
Other	3	6%
Total	53	100%

Despite KLD’s interest in increasing corporate accountability (Gumbel, 1991), only one article directly examined the performance consequences of the ratings. Focusing their efforts on corporate environmental performance, Chatterji and Toffel (2010) found that firms that initially received poor environmental ratings subsequently reduced their release of toxic emissions compared to other firms. Because their research design relied upon an exogenous shock that occurred when KLD expanded

the scope its ratings in 2001, Chatterji and Toffel were able to examine changes in emission behaviors before and after being rated. While ten other studies used the ratings to predict various dimensions of corporate social performance, none of these employed a research design (i.e. pre and post measures with a control group), that would mitigate the threat of selection bias and thus allow the researcher to evaluate whether the firms do indeed respond to ratings.

**APPENDIX B: PHONE INTERVIEW WITH STEVEN LYDENBERG, CO-  
FOUNDER OF KLD, DECEMBER 18, 2012**

**Lydenberg:** This is Steven

**Lewis:** Hi Steven this is Ben Lewis from Cornell

**Lydenberg:** Hi Ben how are you doing?

**Lewis:** Good, is now a good time?

**Lydenberg:** It's an excellent time.

**Lewis:** Alright. Well I appreciate your willingness to talk to me today. This will be a great help to my dissertation. Did you receive my email that I sent yesterday?

**Lydenberg:** No I don't think I did.

**Lewis:** Okay, no worries. I just sent a list of questions that I thought might help frame our discussion. But just to provide a little bit of background, the study that I am proposing is similar to Mike Toffel's work where they look at the performance effects of the KLD ratings. They, if I recall correctly, were specifically focused on the environmental ratings and what they found was that firms that received poor ratings were more likely to improve their environmental performance over time. The question that I am looking at is very closely related but I am looking at the effects of positive ratings, that is, how do firms respond to being recognized? Rather than being singled out as poor performers, how do they respond when they are recognized as superior performers? The particular rating that I am actually looking at is the charitable giving rating which is given to firms that have given at least 1.5% of net earnings before taxes to charity. In my study, I look at how firms respond to being recognized and rated as a charitable organization. So that's where I am coming from. I just have a couple of questions broadly speaking about the ratings in general. I was wondering if we could go through them. Is that okay?

**Lydenberg:** Sure with the understanding that I was involved with KLD from 1990–2001.

**Lewis:** It's been a while I understand. If you can't recall that's totally fine. Now . . . as I presented my research to other people, one of the questions that keeps coming up is "What is the primary purpose or objective of KLD ratings?" Some of the statements that I read about the purposes of the ratings revolve around the idea of increasing transparency and providing information to investors who care about these issues. But I was also wondering to what extent were the ratings issued as a way to motivate companies to improve? When I talk about this with others, they seem to be skeptical and say "well it seems like they are just providing information, they don't really care

about the consequences.” But based on what I have read, both your work and that of Amy and Peter, it seems as if your objective goes beyond just providing information and you actually care about the consequences of these ratings. I wondered if you could comment on that.

**Lydenberg:** I think that is essentially accurate. We approach this from a slightly different angle which is from the investor’s perspective rather than the company and manager’s perspective. We had two primary objectives when it began. One was the creation of the Domini Index and the other was the database and we were very explicit about the purposes of the index. There were 3 purposes of the index. Let me see if I can recall them now. One was to test the proposition that screening companies, setting standards for companies did not necessarily harm performance. The index was set up so that it matched exactly the methodology for maintaining the S&P 500 index, so those two indexes could be compared over time. The second purpose was to provide investors with a set of companies that were investable from a socially environmental point of view and the third was to create a financial product that people could invest in. The profiles of the companies, that is, the ratings of the companies, were made in creating the index to help us understand all of the profiles of the companies. The ratings were also used by money managers who had clients interested in social investing. Because social investors come in all shapes and sizes, that is to say they’ve got a variety of different concerns, we allowed the money managers to use our data in a variety of ways that would serve different clients with different social thresholds. That’s why we didn’t give absolute ratings to companies. In the initial years, we just gave indications of strengths and concern in a variety of different areas. Implicit in all that but not explicit is the thought that investors should invest in companies that have stronger records and that presumably companies should want to attract these investors and perform well and improve their performance. That was implicit in everything that we did but it was coming from an investors point of view so it was not quite as explicit.

**Lewis:** Okay, that’s what I presumed. When I’ve read statements about the objectives of the KLD ratings, it was often, exactly as you mentioned, to provide information. However, in your book about driving a corporate interest or driving corporations toward public interest, it seems as if implicit in all of this work is this idea that providing this information will lead companies to improve their social and environmental performance.

**Lydenberg:** Yes, I have no problem with that it is implicit in everything that we do.

**Lewis:** Great. It’s nice to have that confirmation then. Moving on. So . . . the way that my study is designed, I look at how firms respond when the ratings were first issued in 1991. One of the questions that I get on this study is “How do you know that companies really cared about their ratings?” Do we have any evidence that they actually did respond? I tried to find some media articles and from what I could tell a number of companies would issue a press release when they were included on the index. I was just wondering if you have any anecdotal evidence or stories that you

could tell about whether firms actually did care about their ratings and whether they did respond to them.

**Lydenberg:** I can't give you a definitive answer on that but here are some facts that may be helpful to you. In the process of profiling a company we updated these profiles every year. We sent our profiles to every company for review and comment. So we know as a fact that every company at least had the theoretical ability to be aware of their profile and what we were saying about them.

**Lewis:** But you could also say that some of them didn't care, right and they probably just ignored the letter, right?

**Lydenberg:** We didn't do an actual count of those companies that responded but I am going to say that it was in the 10% range that provided us with additional information, they commented on our report or something like that.

**Lewis:** Okay, and for these companies that responded, how did they react? Were they upset? When they were providing information was it often to help them be perceived in a better light?

**Lydenberg:** We asked them for factual corrections and additional information. They provided both. Different companies responded at different levels. A lot of the larger companies would send us factual material and some of them would send us simply comments on a range of things. I can only recall one time when a company threatened to sue us if we published that information. On the whole I would say that the ones that did respond did so in a cooperative spirit.

**Lewis:** Now, I know the ratings that you issued were based on annual profiles, but were they done at the end of the calendar year or were they done throughout the year and then just updated as information came along? I'm just wondering about the timing of the ratings.

**Lydenberg:** We had a rolling profile schedule. We were continually profiling companies, the same companies at the same time of the year every year, working our way through what was originally 650 companies. Later it was more. All companies were profiled once a year but on a rolling basis. Then we in effect did what we called "freezing the database." Once a year we froze the ratings to provide an annual snapshot of corporate social performance.

**Lewis:** That's why I imagine the ratings I have, the binary, the zeroes and ones.

Lydenberg: Yeah.

**Lewis:** That makes sense. Now, a number of the ratings are more specific; for example, the charitable giving ratings specifies a performance threshold that companies should meet in order to receive the rating, but others are somewhat to very ambiguous. How are the criteria for these ratings determined?

**Lydenberg:** We had three criteria. One was that we could obtain the information essentially without cooperation from the company. The cooperation of the company was helpful, but if the company didn't cooperate we would at least have some basic information so that meant that we felt that we had at least fairly decent information for every company on every issue. The second criterion was that to a maximum degree it should be quantifiable but we recognized that some of the issues were inherently qualitative but we tried to a maximum degree to get quantifiable issues. The third criterion was that it was meaningful; that is to say, there is a lot of information out there that is quantifiable but we wouldn't know what to make of it in terms of its meaning. The example that I gave then was that there was very good information about companies' contributions to election campaigns but what exactly it meant was not clear. Although we gathered that information because it was quantifiable and available for all companies, we didn't feel that it resulted in a meaningful positive or negative gamut of interpretation. Those are our three criteria for data points that we gathered.

**Lewis:** Okay, I am going to shift a little bit and talk more specifically about the charitable giving rating. Certainly charitable giving can be assessed without cooperation from the company. I think it meets those three criteria that you just mentioned but, I was just wondering why the 1.5% threshold, was there a particular reason?

**Lydenberg:** A general goal for the threshold in the strength and concern indicators was that they captured between 10–20% of the companies. We were looking for indicators where the strength was meaningful, in the sense that it only 10–20% of the companies would actually achieve the positive rating. Sometimes that worked better than others. For example, back in 1990, we had a strength and concern on CEO compensation. The concern was set at \$5 million and any CEO that received compensation of more than \$5 million would receive a negative rating for CEO compensation. Back in 1990, anywhere from 10–20% of the companies received that rating. By the mid-'90s, that percentage was more like 30–40% so we increased the threshold for inclusion up to \$10 million. That was our way of setting thresholds.

**Lewis:** That makes sense. When you look at the ratings from 1991, of the 650 companies that were rated, I believe it was about 75 that received that charitable giving rating so that was just over 10%. Did you have a hope specifically that firms that did not receive the positive rating would then increase their level of contributions?

**Lydenberg:** Implicitly but not explicitly.

**Lewis:** Do you remember what data sources did you use to assess the charitable giving rating?

**Lydenberg:** We had a variety of sources of information published on charitable giving by companies in addition to the companies themselves. I believe it was Corporate Philanthropy Magazine or Newsletter that issued a yearly assessment of

companies or something like that. There was some kind of yearly publications that gave dollar figures for philanthropy in addition to the filings for corporate foundations. Data for those companies were available through the foundation library in Boston.

**Lewis:** One more question that I had is how you deal with conflicting information. Sometimes there is conflicting information between the two different sources and most of the time they are the same but sometimes they're different. How would you resolve a discrepancy if one source says something and the other source says something else?

**Lydenberg:** Right. There are a variety of different methodological issues that we came up. One of them is whether to count in-kind contributions and my memory is, if it serves me correctly, that it did not include in-kind contributions in that number. We looked to the first and foremost corporations for the number. When you couldn't get that, we turned to secondary sources. I don't remember if we had conflicts between the Taft directory and the National Corporate Giving Directory. How we resolved that, I don't remember.

**Lewis:** Okay.

**Lydenberg:** Just one more thing. There were further complications when what do you do with a company who has a loss one year so we had a variety of ways of dealing with those I think we tried to normalize the earnings in some kind of way.

**Lewis:** Okay. One thing that would be helpful for me is to use the same sources of information that you guys were using. I was wondering if there was anywhere where I could actually obtain that specific information that you used when deciding the rating for a given company. For example, I've seen a company profile for GE where it specifically stated that GE gave 1.6% of profits to charity in 1991. Based on what I've read, it seems as if KLD issued not just ratings but actual reviews about the companies and I just haven't been able to find them anywhere.

**Lydenberg:** Right. To access those reviews, you would have to go back to the KLD files for that. Right now the KLD files are currently in storage. I am currently engaged in a conversation with KLD, MSCI, and the Business School Library over at Harvard Business School about getting those files taken out of storage and made available to academics. So you'd have to go back and look at the individual folders and the backup materials to find out exactly where we got our information.

**Lewis:** I know KLD was bought out by MSCI now. Is that something they would be willing to let academic researchers access or is it bureaucratic?

**Lydenberg:** You'd have to contact them to find out. They're in storage somewhere. I really have no idea where they are and how easy it would be to actually find the files.

**Lewis:** That would certainly make my life a lot easier. They have the Socrates database where currently I can look and find similar reviews on companies but they're not historical in the sense that they only give the current snapshot.



**Lydenberg:** We probably did save the ratings every year. I don't believe we saved the actual database. I don't believe there's one place together where you can get all of profiles from 1990–1993. You'd have to go to the specific companies to get those and even those it's a little hard to imagine how you'd get to them.

**Lewis:** What you're saying then is that MSCI doesn't have the files on hand. Is that correct?

**Lydenberg:** Actually, I'm not sure what happened to the paper files. We used paper files starting in 1990 through I'm going to say about 1997, 1998. Then things started to switch over to electronic. But the paper files should all be in storage, they all exist. At least I think they do.

**Lewis:** If somehow I could get access to them that would be great.

**Lydenberg:** Right. Again, we debated at various points whether or not every item on the profile should be footnoted and we decided it was simply too much work.

**Lewis:** You said you're currently working with the Harvard Business School to make those files available to the public, correct?

**Lydenberg:** Well, there's correspondence going back and forth between the business school and MSCI. It's been going on for a year. I'll let you know what becomes of it, but I wouldn't hold your breath.

**Lewis:** Ok. Well, I think those were my main questions. First, I wanted to know your thoughts on KLD's primary objectives and whether there was an implicit moral or ethical objective and it sounds like you confirmed that. Second, I wanted to hear your opinions on whether you thought firms actually responded to their ratings. It appears based on what you said that even if companies didn't respond that they were at least aware of the ratings.

**Lydenberg:** I think it's fair to say that the firm was made aware of the ratings. Beyond that it's pretty much speculation.

**Lewis:** Ok great. Well just to provide a little more information about my results, I find that firms that received the charitable giving rating actually decreased their subsequent contributions after being rated. While I'm trying to work out the theoretical arguments here, I think the reason has something to do with the uncertainty that firms face about how much they should give. And then along comes this third party rating that's essentially sets a standard for being recognized as a charitable organization. And I think what happened is that many of these firms saw the new threshold for recognition as an acceptable appropriate level and give and thereby decreased their subsequent contributions to the threshold level.

Lydenberg: Hmm.

**Lewis:** I'm still working on my analyses and collecting some more data. But that's what my initial findings demonstrate.

**Lydenberg:** Hmm, couldn't it also be a general shift in the philosophy of corporate giving during the 1990s.

**Lewis:** It certainly could be. However, I used as control group firms that were never rated to rule out that explanation. So when I say they reduced their contributions, it's relative to this control group of firms that were never rated. In any event, that's where I'm at, so if you're interested, I'd be glad to send the paper to you when I'm done.

**Lydenberg:** Absolutely yes. I would be very interested.

**Lewis:** Great. Well, I appreciate your time. This was very helpful to me.

**Lydenberg:** Okay, any time.

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