The Business of Business: Re-Modelled in Economic and Ethical Terms

Avshalom M Adam and Tal Shavit

Avshalom M Adam (Ph.D)

MBA Program,
College of Management,
7 Rabin Ave.,
Rishon-Le'Zion. Israel

Phone number: 972-545752276
E-mail: avshalomadam@gmail.com

Tal Shavit (Ph.D)

MBA Program,
College of Management,
7 Rabin Ave.,
Rishon-Le'Zion. Israel

Phone number: 972-522920868
E-mail: shavittal@gmail.com

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The article analyses the business of business and comes to the view that the role of business is to balance all stakeholders' interests while giving relative dominance to the interests of investors, over those of other stakeholders.

Based on this understanding, we propose an economic model, which describes the nexus and interactions between the interests of stakeholders, and develops a set of functions aimed at achieving better management of risk through corporate socially responsible (i.e. CSR) investment.

The model takes into account the utilities of the corporate officers, short term and long term investors. All three functions are considered by the Board of Directors, who are deemed the final arbiters with respect to firm decision-making and the body to whom executive management owes fiduciary duties. Finally, a decision rule is developed that defines the circumstances under which the Board of Directors will consider to invest corporate funds in CSR.

Authors' keywords: Stakeholders' interests, Corporate Socially Responsibility (CSR), Risk management, decision making, Long term investors, Short term investors.

Introduction

What is the business of business? The literature offers three alternative approaches to understanding the purpose of the corporation. The first is to consider exclusively the interests of those who invest in it: its owners, the stockholders or shareholders (Friedman 1962; Friedman 1970). The second approach is to inclusively consider not only those who invest in it but, to an equal extent, also others whose interests are affected by its decisions: suppliers, customers, employees, the local community, and management in its role as an agent for these groups, all of which are referred to as stakeholders (Evan and Freeman, 1988; Evan and Freeman 1993; Freeman 1994; Boatright, 1994; Hasnas, 1998). A third view, which we defend here, also considers all stakeholders, but gives dominance to the interests of stockholders over those of other stakeholders, though the interests of the latter are also considered (Sternberg, 2000; Perrini et al., 2006).

These alternative approaches seek to answer the question that is our starting point in the present paper: "What is the purpose of the corporation?" Logically, there are four alternative answers – the three given above, and a fourth, being none of these. Conceptually, nevertheless, the answers to the question offer ideal types, none of which exist in reality. Each alternative (with the exclusion of the fourth) may serve as a regulatory ideal that would be conceptualised by the economist, and according to which the legislator would construct corporate law and the business person would be expected to behave. Historically, the corporation was created for one purpose: as a financial vehicle to serve the interests of the stockholders (the first alternative answer). Yet, empirically, the first two alternative answers compete in the business market, and, conceptually, they compete in the market of ideas. Thus, the United States tends towards the first approach, with the European Community tending towards the second, in that it seeks to curb investor dominance by giving many more privileges to other stakeholders (Perrini et al., 2006). Our proposed third approach lies between the first two, in that it considers the interests of all stakeholders, yet grants greater privileges to investors. The fourth alternative answer is not viable conceptually or empirically and therefore is not considered further in this paper.

What should be, then, the criteria of choice used by managers in distributing scarce resources among those with claims on a business organization? Our answer to this question may emerge from the reasons underpinning the choice of answer given to the earlier question regarding the purpose of the corporation.

Our contribution lies in formulating the debate on the purpose of the corporation in terms of an economic model and in formulating a normative reply to this question. Specifically, we model the choice of criteria of choice using a set of utility functions that may guide the manager in the distribution of scarce business resources.

Using economic terms, we proposed to combined strategy and ethics, that is, we model an expanded role for business Discussion of the role of business and whether it should play a larger role in society connects directly to the ability of a firm's senior echelons (directors and managers) to construct a corporate strategy with the three-fold aim of surviving, maintaining corporate well being, and prospering in the marketplace, while not endangering society or the planet (Bunge, 1989). A business strategy emerges as an outcome of a process of evaluation in which the corporate set of values is deciphered, these values being those which achieve the aforementioned three fold aim and which reflect the role of the corporation in society and on Earth. The norms which correspond to the set of values (i.e. ethics) may lead to the leadership echelon choosing the desired criteria by which to allocate business capital. Accordingly, this model can be used by executive officers as a risk management tool, to reduce their firm’s exposure to risk by balancing the interests of a variety of stakeholders and by enabling the decision maker’s moral sentiment to play a role. Thus, the model indicates when CSR investment will be to the overall benefit of the company, having balanced all stakeholders’ interests and taken the decision makers’ moral sentiments taken into account. For example, suppose one of the organization’s values is “transparency of information”. As such, it serves as a regulative ideal for which the organizational members design norms, which in turn guide organizational members in their choice of conduct. In such an instance, the proposed model takes into account the moral sentiments of various investors, which, we suggest, must be reflected in the choice made by the Board of Directors and which should, in turn, impact the choices made by the business managers whose moral sentiment is also involved. Furthermore, we stress another aspect of CSR, according to which information on corporate activity regarding the interests of the various stakeholders needs be reported, which results in improved information transparency and enable investors' control.

Business corporate social responsibility, when aligned with a firm's strategy, comprises the corporation's set of values, while its ethics is comprised of the norms that correspond to those values. If, in daily business, the echelon's business conduct reflects choices based on the set of values and norms chosen to guide corporation members in their decision making processes, and these values are therefore reflected in their choice of actions and in their actual conduct (Adam, 2005), then we assert that the corporate exposure to risk is perhaps better managed.

Our contributions in this paper, are: a) A proposed economic model of the managerial decision making process involved in meeting the (broadly defined) interests of the corporation. The model describes the nexus and interactions between the interests of stakeholders, and develops a set of functions aimed at achieving better management of risk through corporate socially responsible investment (i.e. CSR). Our second contribution is embedded in the model, which: b) expresses the moral sentiment of an agent in evaluating what is good and judging what is right with respect to the company, with the consequence that both the evaluations and the judgments need to be addressed in constructing and implementing the corporate strategy and in daily activity. The third contribution, c) is the definition of a set of functions. These are: corporate utility, which is related to the corporate officers' decision-making process; short term investors' utility; and long term investors' utility. All three functions are considered in the course of decision making by the Board of Directors, thus the Board's role is pivotal to the governance of corporate officers, while also serving its foremost duty of protecting shareholders' interests. Our fourth contribution, d) is to assuring information transparency if market exposure and control of the firm and its executives result in decreasing information asymmetry in the market place.

The structure of this paper is as follows: In the Introduction, we offer an overview of the issues dealt with in the paper as well as explicitly stating the assumptions we make with regard to the minimal requirement of the role that the corporation should play in society and on earth. In Part 1, we focus on the conceptual scheme, the concepts used and assumed by the model and their context. In part 2, we present the model, while in Part 3, we summarize the implications of the model and sketch a possible application of the model to be explored in further research.

Part 1: The Conceptual Scheme

When discussing the conceptual scheme used to figure out the "corporate social responsibility of the business", the term "responsibility of the business" needs to be unpacked. What is the business of business? That is, what is the purpose of the corporation?

According to Friedman, the business of business is business. Corporate executive managers are agents of the principals, the owners, and as such the managers have a moral duty, as well as a legal obligation, to manage the firm in the best interests of the stockholders, which is, in general, maximization of returns, while observing the ethical custom and the law of the land (Friedman, 1962; 1970). The assumption made is that corporate profits belong to the legal and therefore legitimate owners of the business, the stockholders. This, in turn, has implications for the procedures by which corporate funds are allocated by executive management. In micro economic terms, the criteria of choice which need to be used by managers in allocating scarce corporate resources should reflect only the interests of the stockholders.

An alternative answer to the question of the purpose of the corporation is offered by Freeman and others, who maintain that the purpose of the business is to serve the interests of a number of constituencies: the community, environment, employees, suppliers, clients and also shareholders (Bearle and Mean, 1932; Evan and Freeman, 1988, Evan and Freeman 1993; Freeman 1994). Rather than solely maximizing returns to the shareholders, subscribers to the second alternative assert that managers should focus on balancing a number of legitimate stakeholder interests, even if those conflict with the interests of the stockholders (Freeman and Gilbert, 1988 ; Evan and Freeman, 1988, Evan and Freeman 1993; Freeman, 1994). The managerial objective "is to maximize sustainable organizational wealth, i.e. all stakeholders' utilities" (Kim and Nofsinger, 2007). Thus, in micro economic terms, the criteria of choice which need be used by managers in allocating scarce corporate resources should reflect the interests of all stakeholders, some of which may be in conflict with those of the shareholders and perhaps even against the latter's interests.

The third alternative answer to the question of the purpose of the corporation, which we adopt for our model, draws on Sternberg's (2000) view that the purpose of the corporation is to maximize long term owner value, while, we add, considering the interests of other stakeholders as a risk function. That is, rather than: (i) maximizing returns for shareholders; or (ii) maximizing all stakeholder utilities; we suggest, (iii) maximizing all stakeholder utilities while giving relative dominance to the shareholders' utilities over those of the other stakeholders. We propose a normative and economic model that comprises a set of functions in which maximizing long term owner value is the primary goal, which can be achieved through the possible decrease in corporate risk exposure associated with investing in corporate social responsibility as a means of meeting other stakeholder needs. Indeed, we stress the possibility of the use of CSR as a risk management tool, which lies at the heart of our proposed model. Thus, in micro economic terms, the criteria of choice which need be used by managers in allocating scarce corporate resources should consider all stakeholders, while giving dominance to the interests of stockholders over those of other stakeholders. Not only empirical considerations are addressed here, but also a normative interpretation, on which we will now elaborate.

Friedman's view (1962; 1970) may be criticised at two levels. Firstly, the executive management of the firm does not bear fiduciary duties to the owners of the corporation (Boatright, 1994). Secondly, the purpose of the corporation need not be only maximization of returns to shareholders, but is, indeed, maximizing long term owner value (Sternberg, 2000). On the other hand, the view that the purpose of the business is to serve the interests of a number of constituencies: the community, environment, employees, suppliers, clients and also shareholders (Bearle and Mean, 1932; Evan and Freeman, 1988, Evan and Freeman 1993; Freeman 1994), is criticised since it offers insufficient explanation as to why the executive management of the firm should owe special fiduciary duties to the firm's stakeholders beyond those based on the legal contracts that may exist between them (Hasnas, 1998). Now, if the executive management owes fiduciary duties to neither the stockholders nor to the stakeholders, to whom do they owe these duties? The answer is: to the Board of Directors of the corporation which hired them.

Given the separation between the two functions of the corporation, ownership (stockholders) and control (corporate officers: upper management and the Board of Directors), our focus is on the normative role of the Board of Directors in constructing the corporation's vision and in monitoring the control of the corporation. This is based on the uncontroversial premise that “directors must act in good faith and with sincere belief that their actions are in the corporation’s and shareholders’ best interests (Kim and Nofsinger, 2007)”. Thus, rather than discussing the stockholders, we shift the focus to the directors, whose purpose in the corporate structure remains to serve the best interests of the stockholders. This job is fulfilled by formulating a variety of tools for control, taking a significant role in formulating the business strategy and overseeing its implementation. Note that we do not delve deeply into the question of what constitutes the corporation’s or the shareholders’ best interests, although we do attempt to obtain a preliminary answer to this question by focusing on the principal issue of how Boards should distribute scarce resources among those with claims on the organization while balancing stakeholders’ interests.

We suggest, then, that since the choice to allocate resources to the goals of CSR is a strategic choice, the point at issue is not so much how the managers should distribute the corporation’s resources, but rather, what criteria should guide the Board of Directors in doing so. We, therefore, focus in this paper on the research question: Should the choice of the criteria to be used by Boards of Directors in deciding how to distribute scarce resources amongst those with claims on a business organization (i.e. the choice of criteria of choice) reflect the first, second or third alternative answers to the question as to the purpose of the corporation?.

The third answer, endorsed and defended here, broadly follows Sternberg's (2000) understanding that the purpose of the corporation is to maximize long term owner value. However, we propose a twist in terms of the relative weight that should be given to non-owner stakeholders in this pursuit vis-à-vis the greater weight given to shareholders. Sternberg defines the purpose of the firm as the pursuit of maximizing the long term value of the business to its owners. She further defines a 'business' as an organization that achieves this end by selling goods or services. She clarifies that this end must be met within the boundaries of the law of the land and the ethical custom; otherwise the organization is not a business. By using the term "value" in the working definition of the term "business", i.e., "maximizing long term owner value" we refer to "financial value" (see a discussion on this issue in Sternberg, 2000, pp. 42-47). The term "owner value" is used here in the sense that the "owner value consists of the present value of the future cash flows that the owners will obtain from the business. These are of two kinds: distributions from the business in the form of dividends or other payouts and the capital gains or losses that are realized when (the owner's financial interest in) the business is sold" (Sternberg, 2000, p. 48). Furthermore, an increase of the corporate value towards that end meets the owner's financial interests in the business is an important part of the term "owner value". However, in this paper we do not discuss ownership in general, rather we confine our discussion to publicly traded corporations, and thus the focus is shareholders' interests. Nevertheless, this discussion may be generalized to ownership.

Our approach to answering the question posed in this paper recognizes that the choice of criteria of choice needs to be assessed in normative and economic terms, and that items that were traditionally considered externalities are actually internalities in disguise. The criteria of choice may be evaluated in a variety of ways. One possible way is suggested here in drawing the border between externalities and internalities. The assessment of internalities and externalities needs to be done by determining whether or not they are in congruence with the business's set of values, with the set of values providing an evaluation of the corporation's ability to survive, do well and prosper without endangering society. Thus, we suggest that meeting the interests of stakeholders is part and parcel of the corporate risk management functions and, therefore, investing in CSR and meeting the interests of the variety of stakeholders, is compatible with a firm's ability to survive, do well and prosper in a viable society, while not endangering society or the Earth.

For example, Milton Friedman suggests (1962; 1970) that, if corporate executives allocate corporate resources to meeting the interests of stakeholders other than shareholders (Friedman's examples are philanthropy and contributions to the environment), the executives are effectively abusing their obligation to shareholders. By allocating resources towards ends which do not directly lead to maximizing returns to shareholders, the corporate officers actually violate their moral obligation to the shareholders. By investing in social causes or taking other non-business oriented initiatives, argues Friedman, the managers effectively tax their employees by lowering their wages, or the customers by raising the service or product price, or the owners, since returns to shareholders are reduced. At the macro level, the consequences of this redistribution of firm resources results in higher prices for its goods or services with this being an infringement on market forces which, thus, has a negative effect on free marketplace mechanisms, and so the interests of all players are negatively affected. Thus, managers who invest in social causes not only act against their moral obligation to maximize returns to stockholders, but also act against the interests of customers and employees. Furthermore, since, in investing in social causes, the business allocates resources to externalities, it inflicts damage on fair competition in the marketplace, and, thus, harms the viability of the marketplace. Without entering into Friedman's argument as to the market consequences of investing to moral causes, if the executive management invests in social causes, and if this investment meets the interests of its non-shareholder stakeholders, this may be a method by which the firm returns something to society, i.e., this may be an expression of the manager's moral sentiment.

However, in scrutinizing Friedman's argument, we pause and suggest that a careful examination of the term "stockholders", or "stockholder's interests" reveals that there may be a variety of groups of stockholders, some of which have incompatible interests. For example, corporate shareholders' interests may differ between short- and long-term investors. Short-term shareholders' interests are likely to include reaping benefits in the short run, while long-term investors may prefer to invest in R&D in the short-term, and maximize owner value only in the long run. According to which criteria are we to choose between the interests of the various investors? In such a conflict of interests, corporate executives might prefer the interests of long-term investors. However, is making this choice the prime duty of corporate executives. In proposing that the duty of the Board of Directors is to maximize long-term owner value, rather than to focus on short-term values, some of the stockholders' interests are overlooked. By contrast, we contend that in pursuing the interests of long-term investors, those of other stakeholders also ought to be taken into account (albeit to a lesser extent), and following Friedman, we stress that managers ought to comply with both (ethical) custom and the law of the land.

In our proposed model, we emphasize that maximizing long-term owner value provides a means of increasing corporate value. Taking into account the structure of the corporation, the strategy and work plan of the organization should be structured and supervised by the Board of Directors. For that body, the crux of the matter is to set the principles by which corporate resources should be allocated to effectively maximize long term owner value.

Yet the Board's concerns are dissimilar to those that Friedman attributes to shareholders, viz., maximizing returns to shareholders. Rather, the Board needs to be principally concerned with the managers' choices in allocating corporate resources to effectively maximize long-term owner value in preference to (but not to the exclusion of) the interests of other stakeholders.

At the micro level: in defence of the third alternative, investment by corporate executives in social causes (CSR) need not be in conflict with the interests of all shareholders or other stakeholders. This raises two questions: a) Do the interests of some shareholders include investment in social causes, and if so, under what circumstances are the interests of those shareholders compatible with those of the other stakeholders, if at all? b) What, then, should be the criteria for preferring one stakeholder group over another in the case of their having conflicting interests? Furthermore, what role should the directors play in making choices at this level? To answer these questions, we propose a theoretical model in which investing to promote non-stockholder interests (i.e. according to the third answer) is compatible with increasing corporate value and thereby maximizing long term owner value.

Our Proposed Model

The model is comprised of a set of functions related to the decision making process undertaken by the Board of Directors. The functions we use are: (i) the corporate utility of management, (ii) the short term investors' utility, and (iii) the long term investors' utility. All three functions are considered by the Board of Directors during decision making, thus the Board has a pivotal role in the governance of corporate officers while serving its foremost duty of protecting stockholders' interests.

In the proposed model, the Board of Directors plays a pivotal role in mediating the relationship between the ownership and the management of the firm, by representing the former and governing the latter. However, experience shows that the impact of the Board of Directors varies and is contingent on its ability to protect the interests of the shareholders in its functions as a governing body. Yet, while the ownership may be divided between short term and long term investors, once their interests are in conflict, whatever choice is made by the Board needs to impact decision making by the firm's executives.

Parameters in the model that need to be considered are risk exposures, transparency of information and its control, decision makers' moral sentiments, and long term and short term profit. These parameters describe the relationship between the firm and its stakeholders so that the interests of both are presented and the value of compatible and conflicting interests is formulated in the Board's decision-making function.

The question arises as to whether the proposed model should reflect regulations and their costs in terms of the firm's capital. This is a problematic issue. Regulatory costs may be represented as a cost affecting all stakeholders, but different markets may be associated with different regulatory costs. We refer to significant changes made to the status of the corporation in US Law, notably, the Sarbanes Oxley Act of 2002. As a result, shareholders of businesses operating in the US retain their legal rights while the Board of Directors and corporate officers acquire a set of duties in which ownership and control are further specified. The regulator clearly mandates through this law that corporate officers should make ethical choices in the use of corporate capital and be personally accountable for their choices. In enacting that law, one of the express interests of the regulator is to protect the interests of the corporation's shareholders as well as to regain the trust of all investors in the market. Our proposed model describes the guidelines for the Board of Directors' decision making process in which, by investing in social causes (CSR), it reduces corporate risk exposure and thereby increases long term owner value. One source of corporate risk is that of incurring penalties for failing to comply with regulations, and, as such, regulations and their costs are inherently included within the risk term in the proposed model.

Ownership and management

Ownership of the firm lies with its shareholders, while control of the firm lies with the Board of Directors, with the latter assumed to protect the interests of the former. As owners of the firm, the basic interests of the shareholders are capital appreciation and dividends. To protect their interests they have several rights, e.g. to receive an annual report of the firm's earning, to inspect the firm's books, to vote on central issues, and to elect members of the Board of Directors to further protect their interests. Other candidates for the Board of Directors are proposed by a committee consisting of current Members of the Board and the Chief Executive Officer. Directors must be elected by the shareholders, but their choice of Directors is limited.

In addition to that, shareholder representation levels vary and are not necessarily proportional. The company strategy and work plan for the firm are designed by the Board and the executive management. A Board may decide to allocate resources to CSR to achieve any one of three aims: 1) as a window dressing to improve the company's relationships with its stakeholder so as to maximize returns for shareholders; 2) as a gift to a good cause independent of the aims of the business; 3) as a combination of the first two options, i.e., as a vehicle to maximize returns, via acquiring a positive reputation while doing the right thing, i.e., meeting the demands of a considered good cause. A corporation's commitment to CSR may be assessed by considering a number of parameters such as: the investment made on improving products or services in a manner that decreases their possible negative impact on the environment; contribution of services to the community that community members can enjoy, or even philanthropy; protection of employees' rights and respect for the human rights of others, be they clients, suppliers, or a community member, to name just an important few. Indeed, Socially Responsible Investment (SRI) indices consider these parameters as social screens for their CSR investments (Cox et al, 2004; Adam and Shavit, 2007).

Ownership divided: long term vs. short term

Increasing the company's value should be the first and foremost interest of all shareholders since it maximizes owner value. The desire to achieve this increase in the short-term versus a willingness to adopt a longer time horizon is likely to depend on whether the investment is short-term or long-term. We argue that where investment in CSR leads to an increase in corporate value, this is most likely to occur in the long term. Consequently, short term investors, who seek a rapid return on their investment, are more likely to oppose it than are long term investors.

Unlike our division between short and long term investors, studies of stock ownership relate to individual, household, and institutional owners. In the US, we see that institutional stock ownership is the more prevalent (Lawrence, et al, 2005). Yet, while institutional stock owners, as well as some household owners, are long term investors, there are those who are short term. Therefore, to determine what constitutes 'stockholder values', the Board and management must first know the extent to which long term and short term investors' interests conflict. Then, they need criteria by which to determine whose interests should be preferred, or how they should be balanced. We approach these tasks by proposing a set of functions aimed at best management practice.

The decision making process in the firm lies with its executive managers. These are chosen by a committee of the Board of Directors and their work is governed by the Board of Directors, who design their terms of employment, subject, in some instances, to the approval or disapproval of the shareholders. Conflicts of interest can arise between some of the investors and the manager. For example, a manager may be eager to show high short term returns and thus may wish to allocate more resources to production and marketing, while some investors may prefer to see a higher percentage of resource allocation go to R&D and CSR. The Board, as the governing body, is in a position to deliberate the conflicting interests and reach a decision regarding the best strategy and work plan, with these determining the consequent resource allocation.

The stakeholder theory of the firm discusses the interests of those who have stakes in the business and the interests of the firm in its stakeholders, which include customers, employees, regulatory bodies, suppliers, and others. Their interests and the firm's vary and are not always compatible. Nevertheless, the firm potentially places itself at risk if it ignores stakeholder interests. The concept of "risk" is defined as the rate of possible future change to firm profit, and is reflected in the expected decrease or increase in its future value**.** Thus, if a firm disregards human rights or customer rights, for example, it may expose itself to various risks including regulatory action to enforce compliance or to tighten the rules (if self regulation was previously allowed, this may be replaced with external requirements),product recalls and Customs bans, law suits for damages, bad publicity or a consumer backlash. Thus, the decision making process needs to take exposure to risk into account. These issues may be dealt with directly or indirectly in the annual shareholder meetings or in the deliberations of the Board of Directors.

Investor choice varies and it may be rational as well as moral. The received view in finance theory suggests that rational investors choose stocks in the marketplace after assessing the stock's value in light of its risk. This process of assessment may involve the investor's moral sentiment and, indeed, investors have been found to buy and sell stocks for reasons including those that reflect their moral sentiments (Cowton, 2004). The term “moral sentiment” reflects values (i.e. what one evaluates as either good or bad). In accordance with this evaluation, the moral sentiment is expressed in the judgment consequently made: to do the right thing or to refrain from doing the wrong thing.

Theory of Values and Ethics

Evaluating what is *good* and *bad* is a choice made in a social context that expands well beyond the borders of any specific business. The decision makers’ evaluation of good and bad manifests itself in its set of values. These values, in turn, shape the corporate strategy. The choice of values reflects three levels: firm survival; well being; and prosperity. Therefore, the choice of a set of values needs to be made by the corporate executive officers and Board of Directors, as they are the only ones possessing the information needed to assess these levels. By way of contrast, norms are expressed as a judgment of the *right* thing to do or the *wrong* thing to refrain from doing, and they correspond to the set of values. The choice made in the decision making process and the action taken could be judged as right or wrong in terms of the set of corporate values. The moral sentiment of a person involves evaluation and the judgment of the social situation (Bunge, 1989). Thus, the commitment one makes towards the environment, to a fellow being, to human rights etc., all of which promote a sustainable world and thereby contribute indirectly to firm survival, well-being and prosperity, may be expressed in the Board’s choice of corporate values.

Investing in social causes (CSR), according to those who subscribe to the second alternative answer, needs to be done in conjunction with mechanisms assuring transparency in terms of what the corporation achieved (or failed to achieve) against measurable targets. Corporate social and environmental initiatives may vary, yet the measurement of all social, environmental, as well as financial audits and reports should for transparency in the realm of corporate activities. For example, an environmental initiative, say, a claimed decrease in polluting emissions or improvement in waste treatment methods, should be measured and reported against the relevant standards, where these exist, and against the company's discharge permit(s), where applicable. The initiative should also take place in the context of recognized best management practice, including development and maintenance of environmental management systems in line with, for example, the ISO 14000 series of standards. Discharge permits routinely require the company to report back to the regulatory authority, which may or may not make the reports public. Similarly, achieving ISO 14001 certification does not necessarily ensure that the information gathered becomes publicly available, though it does provide a self-regulatory means for controlling the corporation's activities. Thus, while corporations are not necessarily legally obliged to act in a transparent manner, some degree of oversight of compliance is assured by regulatory agencies and by the fact that the exhaustive process of obtaining ISO certification entails external audits of the company's systems and performance against its management system's requirements by a third party, followed, post-certification, by on-going surveillance audits and periodic re-certification. Thus, problem of asymmetry of information, i.e., as relating to insufficient transparency in the information available to finance markets, is partly resolved.

Part 2: Model of the Managerial Decision Making Process:

When does Investment in CSR make Good Business Sense?

We describe the nexus and interactions between the interests of the executive managers of the firm, the Board of Directors and the investors as follows:

Insert Figure 1 about here

The model we propose aims to explore the following issues: Under what circumstances may investment by the firm in CSR conflict with the interests of some of its shareholders and management, if at all? Do the interests of some shareholders include investment in CSR? Which shareholders would prefer the firm to invest in CSR? Under what circumstances would the interests of shareholders and those of the firm's management and its Board of Directors be incompatible? Under what circumstances would the Board of Directors have an incentive to invest in CSR?

Utilities utilized in the model

In this model, we refer to three different utilities.

(a) The Firm utility, which relates to the managers' decision-making process.

(b) The Short-term investors' utility.

(c) The Long-term investors' utility.

All three utilities are taken into consideration in the Board of Directors' decision-making process.

Parameters affecting the utilities.

For each of the utilities, we refer to the following parameters:

(a) Long term profit (LP)

(b) Short term profit (SP)

(c) Risk (R)

(d) Decision-maker's moral sentiments (S)

(e) Information exposure and Control (I)

CSR represents the magnitude of the investment by the firm in corporate social responsibility. We suggest that the CSR of the firm may be determined by the set of functions offered in the concept of managing risk.

The Profit (LP and SP):

We assume that CSR has a positive effect on long-term profit (LP). Baumol (1991) suggests that social investment improves the firm's productivity and leads to higher profit. Husted and Salazar (2006) suggest that social investment obtains additional benefits for the firm, such as a good reputation and differentiated products that, according to McWilliams and Siegel (2001) and Reinhardt (1999), allow the firm to charge a price premium, and hire more highly qualified personnel. According to Kanter (1999) and Russo and Fouts (1997), this increases the firm's productivity. The additional benefit is mostly in the long run. Husted and Salazar cite, by way of example, the case of a business that decides to support the community by giving scholarships for technical training programmes. They suggest that the firm's reputation in society improves, and, in the long run, it will enjoy additional benefits, such as the greater availability of a qualified labour pool with higher levels of productivity. Other studies, such as those by Hart and Milstein (1999), Marcus and Geffen (1998) and McDonough and Braungart (1998), suggest that social investment by firms can serve as a driver for technological and managerial innovation, which may influence the firm's profit in the long run.

We define the LP profit as follows:

(1) LP = a*CSR

where a represents the positive effect of CSR on long term profit.

We also assume that CSR has a negative effect on short-term profit (SP). Husted and Salazar (2006) claim that many social and environmental innovations increase costs relative to competitors. Since the additional benefit from CSR investment is mostly in the long run, we expect to find negative effects on the short-term profit.

We define the SP profit as follows:

(2) SP = -b*CSR

where -b represents the negative effect of CSR on short term profit.

In this section, we assume that the short-term loss is not so high as to lead to bankruptcy.

The Risk (R)

The concept of risk is the pivotal point of our paper in that, via this concept, we discuss the firm's CSR. First and foremost, “risk” is the rate of change in firm profit and is reflected in a decrease or increase in firm value. Risk may be represented in terms of the interests of the firm’s stakeholders, in what can be considered a stakeholder model that we will now describe in terms of firm theory. Accordingly, the stakeholder model may be used from three different points of view: empirical, instrumental and normative. First, empirically it enables the interests of a number of stakeholders to be described vis-à-vis the interests of the firm. Second, instrumentally, the stakeholder model allows a display of the interests of various stakeholders and the analysis of the various means available for use in achieving certain ends. Third, from a normative point of view, it may offer a set of norms which allow resolving possible conflicts of interests between firm stakeholders (Freeman and Gilbert, 1988; Lawrence et al. 2005). A managerial view in which CSR is endorsed strategically by the decision makers of the firm allows the firm to survive, maintain its well being or prosper. The stakeholder model enables the specification of the interests of a variety of firm stakeholders, and allows their assessment together with the possibility of estimating the cost of meeting those interests, with the CSR program functioning, from an economic point of view, as a risk management tool.

Following our usage of the term risk we hypothesize that firm management of risk, the firm exposure to risk is reduces with increasing investment in CSR. We define risk (R) as follows:

(3) $R = -c*CSR$

where -c represents the negative effect of CSR on risk.

CSR may be illustrated by a set of parameters and mechanisms. The increase in costs associated with a firm committing itself to socially responsible behaviour may be countered by the benefits it stands to gain from that commitment. For example, Fischhoff et al (2001) show some of the mechanisms by which social unacceptability can affect profitability for agricultural use of Genetically Modified Organisms (GMOs). They suggest that social unacceptability might cost a firm, and suggest that, hanging over firms that use GMOs is the possibility of losing their entire line of business. While Fischhoff et al (2001) discuss risks arising from various stakeholders in the context of the use of GMOs, we generalize their analysis to apply to all firms that fail to invest sufficiently in CSR. Such firms may face unexpected costs from several directions due to their low investment in CSR, as follows:

(a) **Consumers** (both end customers and direct customers) may decide not to do business with a firm, resulting in a loss of sales from specific products or from all product lines. Depending on the specific nature of the firm's perceived failing, it may also increase costs associated with product labelling, product testing, additional advertising, product reformulation, and crisis management.
(b) **Suppliers** may decide not to do business with a firm, causing financial loss.
(c) The **public** may reduce its support by reducing research funds, compared to those awarded to other research facilities. Where an entire sector is regarded as behaving in a manner contrary to the principles of CSR, the public may reduce its support by reducing public research funding to that sector.
(d) Where low investment in CSR manifests in poor working conditions, **employees** may opt to strike in order to improve them. A potential employee may decide not

to work in a firm that invests insufficiently in CSR. Difficulties in attracting talented researchers and employees is a major risk to firms.

(e) The **regulator** may decide to replace self-regulation, including optional CSR activities, with stricter mandatory requirements. The regulatory changes may cause an increase in penalties, and otherwise increase firm costs. Fischhoff et al (2001) attribute lawsuits, capital tied up waiting for resolution, lobbying expenses, mandatory labelling, safety measures, mandatory product/ingredient/component identification, company preservation costs and product reformulation as possible outcomes of what they term "Regulatory Changes and Uncertainty". The future regulation may also affect suppliers' ability to conduct business with firms which do not comply with an expected set of CSR requirements. The suppliers in this case would be taxed or be required to formulate and implement a CSR program as a minimal requirement for competing on contracts. Otherwise, the suppliers will be forced to cut off their business with the firm.

By contrast, increasing investment in CSR reduces risk from all the above directions, as follows:

(a) Changes in regulations and their effective enforcement: The probability of **regulators** enacting additional regulations in future, and the consequent potentially negative effect on firm profit, is reduced, both with respect to regulations applying to the firm's home country and to those of the markets it sells to. Further, the probability of incurring penalties for future actions, and the consequent negative effect on firm profit, is reduced.

(b) The probability of a **customer** boycott, such as Nike faced in 1992 for using child labour to produce footballs, and again in the 1997, for abusing workers' rights in factories in Indonesia, is reduced. Consumer boycotts have a direct negative effect on firm profit due to lost sales, and may also affect firm profit indirectly by forcing a company to take voluntary remedial actions to regain its good name. Fischhoff et al (2001) suggest that such actions may need to include: voluntary labelling, voluntary testing, additional advertising, product reformulation, crisis management, and voluntary identity preservation, with the need to undertake remedial action potentially spilling over to other products.

(c) The probability of **employees** going on strike or filing suit, and difficulties associated with attracting talented employees (Fischhoff et al, 2001) are reduced, so reducing the risk to the firm's profit.

(d) The probability that suppliers will choose not to work with the firm is reduced.

Decision-maker's moral sentiments (S)

This parameter is related to the decision making process and emphasizes the moral sentiment of the decision maker with respect to CSR. In the firm, it is related to the manager's moral sentiments, while in a privately owned company, the decision maker's sentiments are those of the owner(s). With respect to investors, the decision maker's moral sentiment equates to the moral sentiments of the long-term and short-term investors.

Husted and Salazar (2006) suggest that the ability of the firm to voluntarily make CSR investments not oriented towards profit maximization is necessarily due to some form of market power that it enjoys. They present the example of Merck that announced, in 1987, that it would donate $100 million worth of river blindness medication to people in third world countries. The Merck decision has provided some benefits, such as increased employee pride as well as community recognition, however, it is clear that donating the drug does not provide a long-term financial payoff for Merck.

We posit that investment in CSR is a reflection of the decision maker's moral sentiments (S), with S having a positive effect on investment in CSR, as follows:

CSR = d_f*S for the firm.

CSR = d_s*S for the short term investors.

CSR = d_l*S for the long term investors.

where d_f, d_s, d_l represent the positive effect that decision makers' moral sentiments (S) have on investment in CSR.

Rearranging, and redefining the coefficients to avoid division, we can write:

(4.1) S = $\mathrm{d_f}$*CSR for the firm.

(4.2) S = $\mathrm{d_s}$*CSR for the short term investors.

(4.3) S = $\mathrm{d_l}$*CSR for the long term investors.

where $\mathrm{d_f}$, $\mathrm{d_s}$, $\mathrm{d_l}$ moderate the relationship between the moral sentiments (S) of the firm's managers and of its short-term and long-term investors, respectively, and investment in CSR.

Information Exposure (Transparency) and Enabling Investors' Control (I)

This parameter is also related to the corporate decision maker's decision-making process.

An increase in the firm's investment in CSR that translates into inclusion on a socially responsible investment (SRI) index increases the firm's information exposure to public scrutiny and makes the firm more susceptible to stakeholder opinion, since it must declare its investments in production line changes, human resource work terms etc. Moreover, the firm is under greater control by the public since it is required to work under an expanded set of standards, including ethical norms. Cowton (2004) suggests that the implementation of ethical investment practices by investors requires them to obtain additional information, which is the key to effective ethical investing (Harte et al, 1991).

Disclosing information on the contribution of a corporate to CSR in fact increases the exposure of information on the firm. Thus, it improves the transparency of its conduct and its actual conduct in the market. To illustrate: Angel and Rivoli (1997) suggest that any information, including information on CSR, has a direct impact on a firm's stock price. Richardson et al (1999) suggest that information about CSR is important for investors since contamination of the environment may affect future suits and require site restoration. However, Li et al (1997) assert that firms reveal information strategically, and leave managers with the discretion as to what to disclose. Zeghal and Ahmed (1990) suggest that there are a variety of sources of information about firm's commitment to CSR other than the information disclosed by the firm itself, for example, independent analyses made by experts in the market.

We define information exposure and inspection (I) as follows:

(5) $I = e*CSR$.

where e represents the positive effect of CSR on information exposure.

CSR reporting is a means to transparency and thus it relates to stakeholder dialogue (Van Marrewijk, 2003); it poses a challenge to corporate officers' integrity when a company, in its CSR disclosure, must report less attractive details or respond to criticism (De Tienne and Lewis, 2005). The importance of transparency is that it provides a means for improving the ability of stakeholders to audit the conduct of the corporation.

The utilities

The firm's utility:

Here, the term "firm" represents the decision making process of its managers. Long term profit (LP), short term profit (SP), and decision-maker's sentiments (S) all positively affect the firm's utility, while risk (R), and information exposure and control (I) negatively affect the firm's utility.

We define the firm's utility as follows:

(6) $U(Firm) = lp_f*LP+sp_f*SP-r_f*R+s_f*S-i_f*I$

or

(7) $U(Firm) = lp_f*(a*CSR) + sp_f *(-b*CSR) - r_f *(-c*CSR) + s_f*d_f*CSR - i_f*(e*CSR)$

where lp_f, sp_f, r_f, s_f, i_f, are the coefficients that separately impact each component of the utility function of the firm

If:

(8) $lp_f*a - sp_f*b + r_f*c + s_f*d_f - i_f*e > 0$

then the firm will invest in CSR.

The Long term investor utility.

Long term profit (LP), short term profit (SP), the decision-maker's moral sentiments (S), and information exposure and inspection (I) positively affect long term investor utility. Risk (R) negatively affects long term investor utility.

We define long term investor utility as follows:

(9) U(long term Investor) = $lp_l*LP+sp_l*SP-r_l*R+s_l*S+i_l*I$

or

(10) U(long term Investor) = $lp_l*(a*CSR) + sp_l*(- b*CSR) – r_l*(-c*CSR) + s_l*d_l*CSR + i_l*(e*CSR)$

If:

(11) $lp_l*a – sp_l*b + r_l*c + s_l*d_l + i_l*e > 0$

then the long term investor will encourage the Board to invest in CSR.

The Short term investor utility.

Long term profit (LP), short term profit (SP), the decision-maker's moral sentiments (S), and information exposure and inspection (I) positively affect short term investor utility. Risk (R) negatively affects short term investor utility.

We define the short term investor utility as follows:

(12) U(short term investor) = lp_s*LP+sp_s*SP-r_s*R+s_s*S+i_s*I

or

(13) U(short term investor) = lp_s* (a*CSR) + sp_s*(-b*CSR) – r_s*(-c*CSR) +

s_s*d_s*CSR + i_s*(e*CSR)

If:

(14) lp_s*a – sp_s*b + r_s*c+ s_s*d_s + i_s*e > 0

then the short term investor will encourage the Board to invest in CSR.

More assumptions

(a) For long term investors, the effect of long term profit on U(long term investor) is higher than the effect of short term profit on the same, so that: $lp_l > sp_l$,, and vice versa for short term investors, for whom $lp_s < sp_s$.

(b) We also assume that long term investors view long term profit as being more important, and short term profit as being less important, than do short term investors, so that $lp_l > lp_s$ and $sp_l < sp_s$.

According to this condition, short term investors are less encouraged to invest in CSR than long term investors, since short term profit is negatively affected by CSR.

The Board of Directors' decision-making process

The Board of Directors takes into consideration the interests of the 3 players: the firm's managers, and its long- and short-term investors.

We define the Board of Directors' decision-making value (BDV) as follows:

(15) $BDV = \alpha * V(\text{Long term investors}) + \beta * V(\text{Short term Investors}) + (1-\alpha-\beta) * V(\text{Firm})$.

Where:

V is a function having one of two possible values:

1: In favour of CSR

0: Against CSR

α represents the weight the Board gives to long term investors' interests in making its decision.

β represents the weight the Board gives to the short term investors' interests in making its decision.

$(1-\alpha-\beta)$ represents the weight the Board gives to the firm's interests in making its decision.

Our first assumption is that the weight the Board gives to each stockholder is not equivalent to the percentage of stocks held by that investor. For example, assuming that short term investors hold 40% of the stocks in the firm, the weight given by the Board to the interests of short term investors (β) might be more or less than 40%.

The next assumption is that the Board has a decision rule, which determines whether the firm will invest in CSR or not. The decision rule is to invest in CSR if:

(16) $BDV > \gamma$

For $\gamma=0.5$ the Board is CSR neutral, for $\gamma>0.5$ the Board is CSR averse, while if $\gamma<0.5$ the Board is biased in favour of CSR, since the decision to invest in CSR is accepted with no need for a majority of investors being similarly in favour.

A decrease in γ increases the possibility of raising long term owner value. For example, assume $\gamma=0.3$, and only the long term investors are in favour of investment in CSR. In this case, the long-term investors need only a weight of 30% in the Board's decision-making process (i.e. $\alpha>0.3$) to convince the Board to decide to invest in CSR.

Part 3: Conclusions, Implications and Model Applications

Our proposed model describes the Board of Directors' decision making process regarding investment in CSR, and shows how investment in CSR may increase long term owner value by reducing risk in the long run. It should be noted that we do not deal with the sum of investment in CSR and how it links to corporate performance, but rather describe the managerial decision making process. The set of stakeholder interests is depicted in the firm risk function. The model enables management to assess exposure to risk in the event that stakeholders' interests are not met. This function is subordinate to the set of utility functions of the firm. Thus, we are able to show that stakeholders' interests may be expressed in the managerial decision making process of the Board of Directors, which is charged with protecting shareholder interests.

We posit that shareholders' interests can be protected only if exposure to risk is minimized. Allocating firm capital to stakeholders' interests by means of investment in CSR projects reduces risk – but the payoff is likely to occur only in the long term. Since stockholders may have a long-term or short-term financial horizon, meeting stockholders' long term interests is of little relevance to short term stockholders who, in consequence, are unlikely to support investment in CSR. By contrast, such investment is likely to appeal to long term investors and, taking into account the moral sentiment and risk exposure of the players, we set out the conditions under which long term investors and the Board are likely to support investment in CSR even at the expense of short term profit. Note that, in setting out these conditions, we exclude activist investors, who are beyond the scope of the model.

Our model has many potential applications. For example, it can explain what encourages American firms to increasingly invest in CSR (see Fortune Global 100, July 2006), not withstanding that, in contrast to their British counterparts (Cox et al, 2004), they are not subject to any regulatory pressure to do so. In the UK, regulatory pressure comes indirectly, in the form of regulations stipulating that institutional investors (being long-term investors) must invest a specific part of their portfolio in businesses committed to CSR (Cox et al., 2004, 31). The effect of these regulations on UK corporations is to tilt the balance in favour of investment in CSR in order better to attract long term institutional investors.

In terms of our model, the fact that institutional long-term investors in the UK are in favour of CSR means that:

$lp_l*a - sp_l*b + r_l*c + s_l*d_l + i_l*e > 0$

Thus, the power of long term profit is higher than the power of short term loss for these investors.

Investors in the US comprise both institutional and private investors with a long term strategy. Many of the private investors invest their own pension fund. In addition to that, the types of institutional investors vary, including pension plans, mutual funds, insurance and banking institutions to name an important few (Ryan and Schneider, 2002). The model can explain what encourages American firms to increasingly invest in CSR in that less-regulated environment.

Our model can also aid regulators in identifying how to influence firms to invest in CSR. Given that long term investors are more likely to encourage firms to invest in CSR than short term investors, rules that favour long term investment, such as tax exemption or tax reduction on capital invested in the long run, may encourage investors to adopt a long term horizon.

The regulator can also influence investors by affecting short term profit and loss. For example, investment in the short run can improve the financial performance of businesses: e.g the Excellence Leadership (XL) Program through which the US Environmental Protection Agency provides firms with incentives for CSR investment. Intel's implementation of the XL Program requirements is a prime example of an improvement in financial performance due to this act by regulators, notwithstanding that there were also negative results in some other participating companies.

This is expressed by the following: Since $lp_l > sp_l$, it is reasonable to assume that:
$lp_l*a – sp_l*b + r_l*c+ s_l*d_l + i_l*e > 0$

However, as the story of Merck’s investment in donating river blindness medication shows (funds allocated were at the cost of ~$100M with no subsequent return on equity or market value in the ensuing 10 years), this reasonable assumption does not always hold. Thus, the strong affect of CSR on short term profit and its weak affect on long term profit might cause this condition to be negative ($a < b$ or $lp_l*a–sp_l*b+r_l*c+s_l*d_l+i_l*e < 0$). Further research is required to tease out the circumstances under which the condition is negative or positive. Since we do not offer an empirical test of the model’s predictive ability, additional research is needed to test cases in which the decision making process take place.

Summary

The article analyses the business of business and comes to the view that the role of business is to balance all stakeholders’ interests while giving relative dominance to the interests of investors, particularly long-term investors, over those of other stakeholders. Based on this understanding, we propose an economic model of the managerial decision making process involved in seeking to advance the (broadly defined) interests the corporation. We present a model, which describes the nexus and interactions between the interests of stakeholders, and develops a set of functions aimed at achieving better management of risk through corporate social responsibility. The model takes into account the utilities of the corporate officers, short term investors and long term investors. All three functions are considered by the Board of Directors, who are deemed the final arbiters with respect to firm decision making and the body to whom executive management owes fiduciary duties. Finally, a decision rule is developed that defines the circumstances under which the Board of Directors will consider it in the overall interests of the firm to invest corporate funds in CSR]

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Figures

Figure 1: interactions between the interests of the executive managers of the firm, the Board of Directors and the investors.