

PRINCIPALS VS. PRINCIPLES:
WHAT DO MANAGERS DO WHEN GOVERNANCE IS SLACK?*

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Abstract

The separation of ownership and control in corporations opens up the potential for moral hazard. Thus it is conventional wisdom that managers who are not closely monitored pursue personal goals rather than maximize shareholder wealth. Yet little is known about what these goals are, despite the importance of understanding manager behavior when designing corporate governance rules. This paper provides new insights into managers' personal preferences by studying the variations in corporate environmental and social performance associated with different corporate governance provisions. I employ a unique dataset on corporate governance and corporate social responsibility and exploit variations in takeover defenses to analyze differences in managers' behavior. I find that with weaker governance, more resources are allocated into environmentally and socially responsible objectives and away from core responsibilities. These findings support a theory that ethical principles are important for the subjective well-being of managers.

Keywords: Corporate Social Responsibility, Corporate Governance, Antitakeover Amendments, Firm, Performance

JEL Codes: M14, G34, Q20

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1. INTRODUCTION

The separation of ownership and control of corporations in modern market economies creates potential moral hazard problems.¹ Managers in charge of firms' operations bear little direct financial cost when pursuing their own goals rather than maximizing shareholder value.² Corporate governance mechanisms are used to better align the incentives of managers with shareholders. These mechanisms include legal protection of shareholders, effective boards of directors, regulations in firm charters, performance-dependent compensation for managers, and takeover threats from the market, all of which can be found in today's firm structures. The strength of corporate governance in a corporation determines the strength of the profit constraint in managers' decision making. For example, if managers fear losing their job after a hostile takeover, they may be more inclined to maximize shareholder profits and put their other personal interests aside.

But what are managers' personal interests? When governance weakens, what do managers do with their newly gained freedom? Understanding managers' preferences is important to designing corporate governance mechanisms and to predict impacts of changes in government policy toward corporate governance on firm outcomes, such as the environmental or social performance of the firm. The recently proposed changes in governance rules by the Securities and Exchange Commission as a result of the 2002 Sarbanes-Oxley Act highlight the need for a better understanding in this regard.³ The Act covers issues such as auditor independence, corporate governance and enhanced financial disclosure. The new regulations are aimed at strengthening firms' governance in order to avoid accounting scandals. My research shows that firms' environmental or social performance might also be affected.

¹The idea of moral hazard—management undertaking projects for their own benefits which may not be in the interest of shareholders—goes back to Smith (1776) and Berle and Means (1933). Revived in the 1960s by Baumol (1959), Marris (1964) and Williamson (1964), this phenomenon is now explained in most micro-economics textbooks.

²For managers in the United States, Ofek and Yermack (2000) report a median ownership of 0.06 percent and a mean of 0.75 percent of stocks.

³The Sarbanes–Oxley Act of 2002 is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. The legislation is wide ranging and establishes new or enhanced standards for all U.S. public company boards, management, and public accounting firms. The Act contains 11 sections ranging from additional corporate board responsibilities to criminal penalties, and requires the Securities and Exchange Commission to implement rulings on requirements to comply with the new law.

The existing literature on the effect of weaker governance on managers' behavior consistently finds evidence that managers pursue personal interests when given more freedom. Bertrand and Mullainathan (1999) find that higher protection raises CEO compensation. Looking at plant level outcomes, Bertrand and Mullainathan (2003) find that workers' wages increase with weak governance and that there are fewer plant openings and closings. Garvey and Hanka (1999) look at firms' leverage and find that managers with more protection reduce their use of debt. Finally, Gompers, Ishii and Metrick (2003) conclude that weaker governance leads to lower firm performance, while capital expenditure and acquisitions increase. My research contributes to this literature and expands our understanding of managerial behavior to the domain of social and environmental preferences.

Data limitations make it hard to study managers' preferences and limit the existing literature on manager behavior and governance. It is difficult to find comprehensive data on manager decisions or on firm outcomes from which we can plausibly infer manager decisions. External accounting data is too aggregated to reveal much about management preferences and more disaggregated firm measures are hard to come by since firms are naturally worried about revealing too much about themselves in a competitive market environment. My study is unique as I overcome this problem by merging two previously distinct firm level datasets. Corporate governance data on anti-takeover provisions from the Investor Responsibility Research Center is combined with data on firms' Corporate Social Responsibility (CSR) performance from KLD Research & Analytics. Data on firms' social and environmental performance offers a way to observe outcomes as a result of specific management decisions. How much charitable giving a firm does, or how strong its voluntarily pollution prevention programs are, is decided by the firm's management.⁴ Other firm characteristics are obtained from Compustat North America, resulting in a large longitudinal panel.⁵ The combination of the three datasets allows me to observe how changes in corporate governance affect managers' behavior with regards to social preferences, conditional on other firm characteristics such as size and earnings. The large number of social and environmental in-

⁴Galaskiewicz (1997) concludes in his study that managers have a big influence on the amount of firms' charitable givings.

⁵My matched sample spans an unbalanced panel of 2,230 firms over 15 years with a total of 12,896 firm-year observations.

dicators in the KLD data allows me to look at a variety of decisions which reflect managers' diverse ethical principles.

My results suggest that managers with more protection engage in stronger pollution prevention, give more money to charity, promote employment and equal opportunities for women and minorities, implement progressive gay and lesbian policies, and improve benefits to workers. I also find that managers with weak governance neglect some of their core duties so that the firm incurs more environmental fines and regulatory problems and produces fewer profitable innovations.

My empirical findings are consistent with my theoretical hypotheses derived in this paper, which I title the 'good life' theory of manager preferences. My theory is based on the finding in the psychology literature that people want to contribute to the greater good and are not solely self-oriented in their preferences.⁶ The relative differences between the profitability of a type of CSR and its effect with respect to the managers' ethical preferences explain why we see an increase in some types of CSR while observing a decrease in others.⁷

In addition, I connect two areas of relevant literature that have traditionally been separated in my paper. One area can be defined as the management literature which looks at causes of CSR and how it affects firms' profitability. The second area of literature is spread across the fields of law, management and finance, and looks at the effectiveness of anti-takeover provisions in protecting the interest of shareholders. Anti-takeover provisions (ATPs) are takeover defenses in the form of bylaws or amendments to the charter which restrict shareholder rights.⁸ Their aim is to make unwanted takeovers by raider firms more difficult. The popularity of ATP adoptions was a response to an increased threat of hostile takeovers driven by the rise of the junk bond market in the 1980s. When putting an ATP in place, the potential harm of a hostile takeover is traded off against increased manager freedom. The empirical literature on the link between ATPs and shareholders wealth finds mixed results and leaves the question open as to whether the main effect of ATPs is a

⁶For the discussion on the primary causes that increase an individual's life satisfaction, see Diener, Suh, Lucas and Smith (1999) and Oishi, Diener, Suh and Lucas (1999).

⁷A graphical illustration of the varying constraints managers face for different types of CSR is given in Section 2.

⁸While the ATPs are aiming to restrict takeovers by raider firms and therefore sometimes explicitly restrict the rights for new shareholders (e.g., unequal voting rights), most of them restrict the rights for shareholders in general (e.g., supermajority voting requirements for mergers or giving managers golden parachutes).

higher takeover premium or greater managerial entrenchment at shareholders' expense.⁹ My findings support the view that ATPs lead to a costly entrenchment of managers from the shareholders' perspective. More resources are allocated to social and environmental projects with uncertain benefits for shareholder value, while other unambiguously important manager duties get neglected.

Finally, my research also contributes to the specific literature on corporate social responsibility. The main focus of the CSR literature is the link between corporate social performance and financial outcomes of the firm.¹⁰ The majority of researchers find a positive relationship.¹¹ Two criticisms common to all papers in this literature are the unsolved problem of reverse causality and the use of aggregated CSR measures.¹² In my study, I check and control for reverse causality and find that there is no effect of CSR on the installment of ATPs. I also demonstrate the importance of disaggregation in KLD's data by showing how heterogeneous CSR indicators can be within the traditional categories of aggregation.¹³ I therefore argue that the traditional aggregated measures of CSR are not appropriate when we are interested in the effect on firms' financial performance.

A much smaller part of the CSR literature looks at the link between different measures of corporate governance and CSR. Coffey and Wang (1998) find that more managerial control is linked with higher charitable giving, and Mahoney and Thorne (2005) find that Canadian firms have less environmental problems when managers have a long-term compensation plan. McGuire, Dow and Argheyd (2003) argue that increased long term salary incentives lead to a decrease in negative social performance. Again, these past studies can not properly control for some of the unobserved heterogeneity between firms due to the lack of longitudinal data, and they also draw conclusions based on highly aggregated measures of CSR. I contribute

⁹An overview of the empirical literature on links between ATPs and shareholder wealth can be found in Comment and Schwert (1995) and Mahoney and Mahoney (1993). Sundaramurthy (2000) summarizes and extends the theoretical background about if and when ATPs benefit shareholders.

¹⁰Two recent reviews of the theoretical as well as empirical research on CSR are given by Margolis and Walsh (2003) and McWilliams, Siegel and Wright (2006).

¹¹A comprehensive meta-analysis of this large literature on the CSR-performance link was done by Margolis and Walsh (2001). Two significant individual papers are Waddock and Graves (1997) and Hillman and Keim (2001)

¹²The KLD data are the most comprehensive and most widely used dataset on CSR.

¹³It has been shown in the macroeconomics forecasting literature that with sufficient heterogeneity in the disaggregated data, we lose valuable information when aggregating, see Zellner and Chen (2001) or Auffhammer and Steinhauser (2007).

to this part of the literature by looking at the effect of corporate governance in the form of anti-takeover provisions on CSR employing much longer and wider panel data. My use of panel data allows me to control for unobservable time invariant firm heterogeneity. My theory reconciles the seemingly contradictory findings in the existing literature that weaker governance leads to an increase in CSR but that stronger governance can also lead to an increase in corporate social performance. I show that it is important to understand the relative preferences of managers and shareholders based on their costs and benefits. My empirical findings complement my theoretical approach. Overall, my results suggest an increase in environmental and social performance of firms under weaker governance, but I also find for some types of CSR a shift to a lower performance.

2. THEORY

As discussed above, the existing literature on manager behavior under weak governance finds managers to behave rather opportunistic with regards to shareholder interests. Bertrand and Mullainathan argue that their observations can be explained by a “quiet life” model of manager behavior. Managers with slack governance prefer to avoid difficult decisions and costly efforts. This is supported by their findings of fewer plant openings and closings when takeover laws are in place. They also observe higher wages for workers, even though total factor productivity goes down. This, they argue, is a way for the manager to avoid trouble with employees and unions. Additional support for the “quiet life” hypothesis comes from Malmendier and Tate (2005), who find that CEOs who win awards subsequently write more books and underperform as managers, while getting higher compensations.

In this paper, I suggest that managers seek something more than simply a “quiet life”. I propose that managers seek a “good life” in which they will raise their subjective well-being through a combination of quiet life and good deeds. According to my theory, when governance constraints are relaxed, managers will put more effort and resources into environmentally and socially responsible projects, which were restricted under profitability constraints to a lower level than the manager would prefer. For example, managers could prefer to spend more of the firms’ money on charitable giving or strong pollution prevention

than is economically optimal, or they would like to raise workers' benefits to a level where the firm will not experience an equivalent increase in worker productivity. Most of the 33 CSR indicators in the KLD data fall into this category, where managers prefer a higher level of CSR than shareholders do.

My theory also predicts that managers reduce the effort and resources put into projects that are part of their core duties, such as avoiding fines and penalties for pollution or other violations, when governance is slack. For these types of CSR, the profit-maximizing level will be higher than the managers' preferred level of CSR implementation. In such cases, the effort needed to be put into these core duties to get to the optimal level from the shareholders perspective might outweigh the "warm glow" managers receive from it.

Psychologists have divided the numerous components of subjective well-being into broad sets: cognitive judgments of life satisfaction, and emotional aspects consisting of independent positive effects and negative effects (Lucas, Diener and Suh 1996). The "quiet life" reflects the pursuit of the emotional aspects of well-being. For example, avoidance of conflict with employees will reduce negative effects, while a game of golf will likely increase positive effects. My "good life" theory includes the "quiet life" theory of emotional well-being motives of top managers and extends it to include cognitive life satisfaction components. Many different experiences and actions can contribute to an individual's life satisfaction. As analyzed by Diener et al. (1999) and Oishi et al. (1999), a person's perceived success and their contribution to the greater good enter into their subjective well-being.

In economic terms, this would translate to a manager's utility function in which the firm's level of implemented CSR enters positively. In my model the level of CSR enters the manager's utility function only through the effort (E) the manager has to put in to archive a certain level and the "warm glow" or positive cognitive judgment (G) the manager associates with the CSR performance of the firm. All other arguments that enter the manager's utility have a partial derivative with respect to CSR of zero. When interested in finding the manager's preferred level of CSR, I can then simplify the manager's utility to $U(G, E)$, with its first derivatives $U_G > 0$ and $U_E < 0$. If U is a nicely behaved, concave function with respect to CSR, there exists a unique level of CSR that maximizes the manager's utility. Shareholders are assumed to be purely interested in the returns of their investment in this

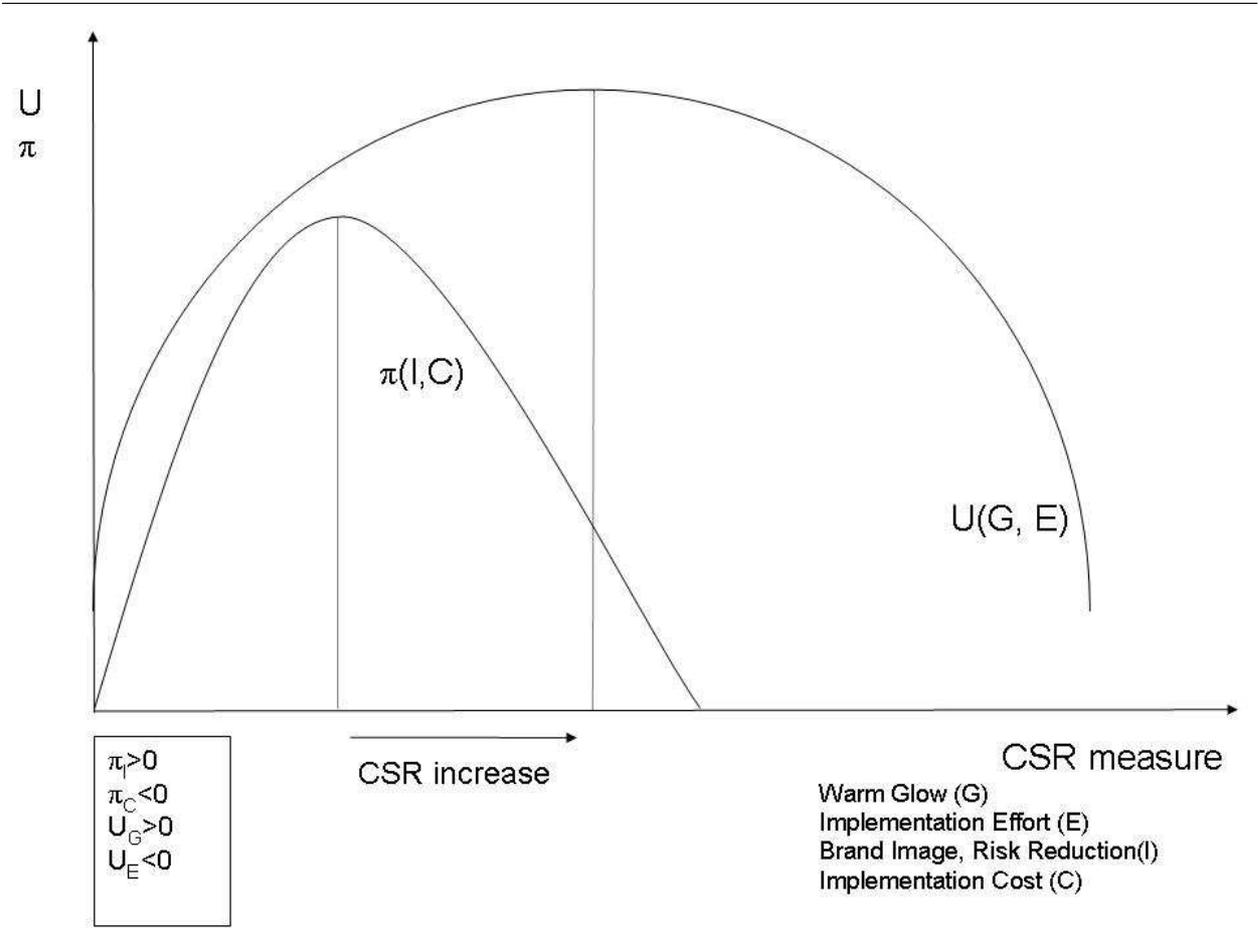
model, in which case their utility with respect to CSR is maximized at the level of CSR that maximizes the firm's present discounted value of profits Π . $\Pi(I, C)$ represents the firm's profit as a function of the costs and benefits of a certain level of CSR. C denotes the cost function and I denotes the (potentially long-run) benefits from CSR. Benefits could, for instance, come from an improvement in brand image or a risk reduction with respect to future environmental accidents.

These two utility specifications represent the differing interests between shareholders and managers. As long as the maximum of both functions does not occur at the same level of CSR, management would want to put forth a different level of CSR. There are two cases apart from the perfect alignment of interests. The manager could prefer a higher or a lower level of CSR compared to the shareholders optimum. Figure 1 shows the case in which the manager prefers a higher level of a given type of CSR. I will refer to this as "type I" CSR. This will particularly be the case for voluntary actions of the firm which have an ambiguous effect on shareholder value at high levels, but give the manager a strong increase in life satisfaction by doing something good. This will also be true for CSR that has a "quiet life" component where the manager may want to avoid negative emotional aspects of subjective well being.

Under strong corporate governance where the manager's actions are fully aligned with shareholders' interests we will be at a level "a" of CSR which represents the profit maximum for the firm. With weaker governance, the profit constraint relaxes and we will move toward the manager's preferred level, denoted by "b" in Figure 1. For this type of CSR the level implemented goes up as corporate governance weakens.

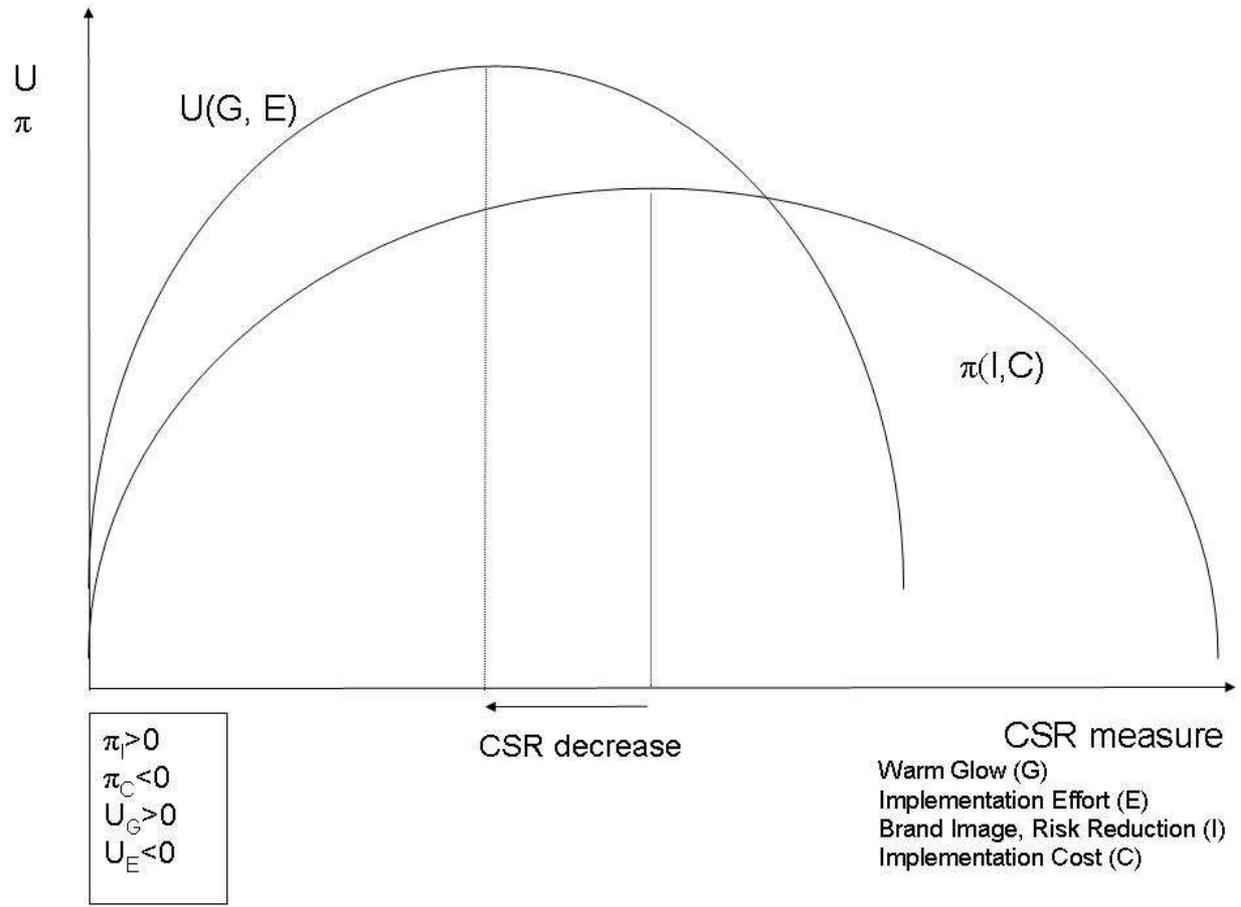
In Figure 2, I illustrate the case in which the manager prefers a lower level of CSR compared to the profit-maximizing level. As discussed above, this might be the case for core duties which require great effort, is outweighing relatively small "warm glow" the manager gets from the implementation of the profit-maximizing level of CSR. As above, under strong governance, we will be at the optimal level from the shareholders point of view, denoted by "a." With a weakening in governance, the manager will have more freedom to follow his personal goals and we would expect to see a decrease in CSR towards point "b." I will refer to this kind as "type II" CSR.

Figure 1: Increase in voluntary CSR as profit constraint relaxes – Type I CSR



It is important to stress that the expected shift in CSR depends on the relative maxima of both manager’s utility and firm’s profit function. In principle, it could be that we have types of CSR where the profitable level is fairly low but the manager prefers an even smaller amount, as the needed effort is high or the “warm glow” from the kind of CSR is particularly small. That would be a type II scenario. In general though, we would expect to have a strong positive correlation between profitable CSRs and being a type II CSR for two reasons. First, we expect to see the manager’s utility maximum in a reasonable range of CSR outcomes. Hence, if something is really profitable (and maybe should not be referred to as a CSR in the first place), we will be in a type II scenario where the profit-maximizing level is far to the right of the manager’s optimum. Second, there is arguably a negative correlation between the profitability of a CSR type and the “warm glow” that managers get from it. Since the “warm glow”, or cognitive life satisfaction, is understood to come from

Figure 2: Decrease in essential CSR as profit constraint relaxes – Type II CSR



projects which contribute to the greater good, the profitability of a certain CSR measure would dampen the cognitive life satisfaction the manager gets from it. A manager knows he or she is expected to perform these tasks to improve the firm’s profitability. This will decrease his personal utility and make it even more likely that profitable CSRs are type II.

To sum up the theoretical approach, managers with more governance slack may devote less of their personal energy and company resources to core or profit maximization (type II) kinds of CSR and will shift their efforts into voluntary ethical projects such as helping the needy or protecting the environment (type I CSRs). Thus, my two main derived testable hypotheses are:

Hypothesis I: When governance is slack, managers increase environmental and social performance on indicators which are less profitable and give the manager cognitive life satisfaction in form of a “warm glow” effect.

Hypothesis II: When governance is slack, managers decrease environmental and social performance on indicators which are profitable and give the manager less cognitive life satisfaction.

3. DATA AND METHODOLOGY

3.1 Data Sources

The main data source used in this paper is CSR ratings by KLD Research & Analytics, Inc.¹⁴ The KLD data is the most comprehensive data source for CSR ratings and is the dominant data used in the CSR research literature. Starting in 1991, KLD rated about 650 companies (including all S&P 500 firms) on issues related to the social responsibility of the firm. The information is gathered from publicly available reports, mandatory filings and supplemental interviews with key personnel at the firms. After enlargements of the firm universe in 2001 and 2003, KLD now ranks over 3000 firms covering the entire Russell 3000 index. Each firm is identified by name, ticker symbol and CUSIP code and is rated on about 100 indicators.¹⁵ The indicators are grouped in qualitative issue categories. The relevant categories for this study which cover the set of environmental and social preferences are Community Relations, Diversity Issues, Employee Relations and Environmental Performance.¹⁶ This leaves me with 33 specific types of CSR rated for each firm.¹⁷ Each of those four categories has multiple strengths and concerns, which refer to outstanding positive types

¹⁴The KLD stands for Kinder, Lydenberg and Domini. KLD Research & Analytics, Inc. is a social investment advisory firm, which rates firms on more than 100 indicators related to CSR.

¹⁵CUSIP stands for Committee on Uniform Securities Identification Procedures. The CUSIP code is a unique identifier for company, issues and the type of security consisting of up to 9 digits.

¹⁶Less applicable categories are screenings of controversial business issues, like involvement in gambling, military or nuclear power. I exclude those, as most researchers do, since these mainly indicate which industry a firm is involved in, a fact that managers normally can't change. The category corporate governance has such motley sub-indicators and the area of human rights has so little data availability that those are also commonly excluded. KLD's product category is also excluded as it can't give us insight into managers' ethical behaviors.

¹⁷I do not look at the indicators in each category which are called "other strengths" or "other weaknesses", as these represent a rating on miscellaneous characteristics of the firm that did not fit in any of the named indicator in the given category. In addition, six indicators had to be dropped from the regression analysis due to an insufficient number of observations for the logit estimator to converge. These indicators were only rated for a small subset of years: "non-us charitable giving", "volunteer programs", "property plant and equipment", "ozone depleting chemicals", "no-layoff policy" and "health and safety strength."

of CSR or outstanding negative CSR respectively. KLD rates indicators as one if firms show a certain outstanding performance and zero if the particular strength or concern doesn't apply to a firm. I will refer to those binary strength and concern ratings as indicators. For example, in the community category, "charitable giving" is one of the strength indicators, and firms are rated with one if they give at least 1.5% of their net earnings before taxes to charity. A concern indicator in the same category, "negative economic impact", is rated as one if the firm's actions resulted in major controversies concerning its economic impact on the community. A complete list of all indicators sorted by categories with a detailed description is given in Appendix B.

Data on anti-takeover provisions (ATPs) comes from the Investor Responsibility Research Center (IRRC) which collects data biennially on anti-takeover provisions, starting with 1500 firms in 1990 and growing to a sample of close to 2000 firms in 2004. The data covers 22 typical anti-takeover defenses commonly adopted by firms.¹⁸ The IRRC derives the data from public sources such as corporate charters, annual reports or 10-K statements. As Gompers et al. (2003) point out, these IRRC listings are a potentially noisy measure but there is no reason to suspect any systematic bias in the measurement error. Also included in the data is the Gompers-Ishii-Metrick index on weak governance, which counts all anti-takeover amendments a firm adopted or laws put in place in the firm's state of legislation, such that a *larger* number in the index is an indicator for *weaker* shareholder rights or higher management power. I will focus my research on a subset of six ATPs which Gompers et al. (2003) classify as manager protections whose adoptions by the firm will lead to a clear weakening in corporate governance.¹⁹ These amendments which were specifically designed to insure directors and top managers against job related liability or to compensate them in case of job termination, are summed to an index which I will refer to as "manager protection" throughout the paper.

I combine both datasets with Standard & Poor's Compustat North America. Compustat is a large and widely-used database reporting a wide range of financial, statistical and

¹⁸A complete list of all anti-takeover amendments with a short description can be found in Appendix I of Gompers et al. (2003) or at the IRRC website in the glossary under www.irrc.com/resources/glossary.htm.

¹⁹Manager protection ATPs give the management more protection from the shareholders by securing benefits in case of a change in control or by limiting liability to their conduct. These six amendments are: Compensation Plans, Contracts, Golden Parachutes, Indemnification, Liability and Severance.

Table 1: Summary Statistics

Variables	1991				2005			
	Mean (std)	Std	Min	Max	Mean (std.)	Std	Min	Max
Market Capitalization (\$ mill.)	4,819	8,980	14	75,605	8,254	23,368	37	367,473
Total Assets (\$ mill.)	10,635	24,144	90	216,922	16,344	82,048	60	1,494,037
Return on Assets	0.044	0.067	-2.67	0.41	0.046	0.089	-1.27	0.39
Manager Protections (6)	2.57	1.22	0	6	2.07	1.16	0	5
Weak Governance Index (24)	9.64	2.71	1	16	9.08	2.59	2	18
CSR Strength (28)	1.21	1.40	0	8	1.45	2.13	0	16
CSR Concerns (19)	0.80	1.28	0	7	1.60	1.65	0	13
Community Strength (6)	0.37	0.62	0	3	0.16	0.53	0	5
Community Concerns (4)	0.03	0.17	0	1	0.11	0.34	0	2
Diversity Strength (8)	0.25	0.55	0	3	0.80	1.17	0	7
Diversity Concerns (3)	0.04	0.18	0	1	0.35	0.50	0	2
Employment Strength (7)	0.23	0.49	0	3	0.28	0.60	0	5
Employment Concerns (5)	0.12	0.37	0	2	0.53	0.69	0	4
Environment Strength (7)	0.23	0.46	0	2	0.14	0.48	0	4
Environment Concerns (7)	0.40	0.80	0	5	0.28	0.74	0	5
Number of firms	572				1702			

The table provides summary statistics for the matched sample of firms for the years 1991 and 2005. The units of variables are in brackets. The numbers in brackets after the governance and CSR categories indicate the total number of indicators in each category in the year 2005 stating the maximum number of points possible in each category. The weak governance index refers to the Gompers-Ishii-Metrick (2003) index where higher values refer to weaker shareholder rights and where the maximum is 24, while the manager protections refer to the subset of provision designed to insure officers and directors against job related liabilities or to compensate them in case of termination.

market information for over 10,000 publicly owned US and Canadian companies. Similar to the other two datasets, the information is gathered from all available public sources and additionally randomly verified. I match all three datasets by CUSIP number and supplement it by checking by hand.²⁰ Summary statistics for my matched sample of 2,230 firms with 12,896 firm-year observations are reported in Table 1 for the first year (1991) as well as the last year (2005) in my sample. It is worth pointing out that the number of firms in my matched panel sharply increased over the period from 572 to 1702. The mean market capitalization of firms in my matched sample has increased from just under \$5 billion to over \$8 billion over the sample period, while the firms' return as a percentage of assets has been fairly constant at a mean of around 4.5%. There is a large variation across firms, ranging from small firms with a market capitalization of under \$40 million to large firms with over \$350 billion for the year 2005.²¹ Average manager protection falls from 1991 to 2005 in the extended sample by about one-half to two protection provisions for each corporation. Firms' CSR performance as measured by the KLD sub-score identifies a lot of zeros in the dataset. On average, in 1991 a firm has just over one strength rated as one and less than one concern in a given category, and only slightly more by 2005.

3.2 Definition of Variables

The existing literature has only used the KLD data in aggregated form.²² In a first step I follow the existing literature and produce results using aggregated measures of CSR on the category level where I subtract for each of the areas (Community Relations, Diversity Issues, Employee Relations and Environmental Performance) the concern indicator ratings from the sum of the strength indicators. The resulting measures of CSR are used as dependent variables in aggregate regressions, reported in Table 3 as a reproduction of results in the literature with my data. However As discussed in the introduction, it is not appropriate to use aggregate measures when there is sufficient heterogeneity among the individual

²⁰After an automated matching of most firms, checking each unmatched entry individually was necessary since neither ticker symbol nor CUSIP number are permanent identifiers of a firm and change over time, a feature which made matching with the correct Compustat firm record rather difficult.

²¹Citicorp is the largest firm in the sample in terms of market capitalization and assets.

²²Ruf, Muralidhar and Paul (1998) and Waddock and Graves (1997) have looked into the best way to weight the different categories of the KLD into a combined index.

indicators. While Mattingly and Berman (2006) find that the KLD strength and concern categories are empirically and conceptually distinct and should not be combined, I am going a step further and argue that there are enormous differences within strength and concern categories that make it problematic to even use an entire strength or concern category, a common practice in the existing literature. The following examples demonstrate my point. The Employee Strength category contains an indicator “union relations” which is rated one if “the company has taken *exceptional* steps to treat its unionized workforce fairly.” Exceptional steps towards unionized workforces indicate a firm’s engagement in non-profitable CSR and are in my categorization a type I CSR. In the same category, we also find an indicator for “employee involvement” which is rated one if “the company strongly encourages worker involvement and/or ownership through stock options available to a majority of its employees”. Employee involvement may be responsible but it is also a recognized practice to increase productivity for the firm and is therewith also potentially profitable, which would make it a type II CSR. We therefore would expect to see the opposite change in this variable compared to “union relations” after governance is weakened. If we use an aggregated measure of the Employee Relations category, these effects could cancel each other out. Another problem with using the CSR indicators in aggregated form becomes apparent in the Environmental Performance category where multiple indicators are industry dependent. Two examples are “substantial producer of agricultural chemicals” or “substantial revenues from sale or indirect combustion of fossil fuels” in the Environmental Concerns category. These indicators are hard to reconcile as a type of CSR firms can influence without changing their main business. In aggregated form these enter the environmental score and would influence my results.

I therefore take a disaggregated approach and make use of the full information of the KLD data, running separate regressions for each CSR indicator as a dependent variable to identify governance effects on type I and type II indicators of CSR. It is important to stress the conceptual difference between CSR strength and CSR concern indicators. Strength indicators have a straightforward natural interpretation. A rating of one for a strength indicator implies a positive outcome for some social or environmental dimensions. Furthermore, if certain strengths are more profitable in nature, we expect them to be a type II case, predicting a

decrease under weak governance. On the other hand, a rating of one for a concern indicator implies that the firm performance negatively affects a social or environmental dimension. Therefore, an increase in concern indicators signals a decrease in a firm's social performance. Nevertheless, if we have a concern which the shareholders would like to get rid off due to its harmful effect on the profitability of the firm (such as "having problems with environmental regulation and paying substantial fines"), we have a case of a type I CSR and predict a shift towards more of this type of CSR if governance is slack. The only thing to not get confused by is, that more of this CSR indicator actually means less social responsibility.

In accordance with my hypotheses, I have categorized each CSR indicator on the basis of the short descriptions given by KLD into a type I CSR, a type II CSR or an ambiguous type for which it is unclear if the manager's desired level of CSR is higher or lower than the profit-maximizing level. Indicators are marked with (I), (II) or (?) accordingly and the categorization is marked next to the indicator name in all tables and in the list of all indicators in Appendix B. For instance, I categorize "charitable giving", "employment of disabled", "(exceptional) union relations" and "(notably strong) pollution prevention" as type I CSRs. These have a less profitable character but a strong potential for a "warm glow" on the manager's side. Therefore, we would expect to see the maxima of the manager's utility function at a higher level of CSR than is optimal for shareholders. On the other hand, indicators like "(deriving revenue from) environmental products and services", "employee involvement (e.g., stock ownership)" and "climate change concern (i.e. substantial revenues from the sale of coal and oil)" are directly linked to maximizing firm's profit and are categorized as type II CSR.

The type I and type II CSR categories that I have created are clearly subjective and might be debatable in some cases. However, these categories represent my best and objective ex ante attempt at categorizing according to my theoretical structure.²³ I also provide a second alternative categorization based on a profitability analysis of each indicator. This will

²³A colleague and expert in the are of corporate social responsibility, Graham Bullock, rated all 33 indicators independently. We had an disagreement in 5 of the 33 indicators. He rated 10 more indicators as ambiguous and rated 18 of the indicators the same way. The indicators that Bullock rated different where "Tax Disputes", "Regulatory Problems", "Work/Life Benefits", "Gay and Lesbian Policies" and "Retirement Benefit Strength". For an overview of overlap and differences in Bullocks and my rating see Table 6 in Appendix C.

give an indication if we have a type I or II CSR in light of the expected strong correlation between profitability and being a type II CSR, discussed above. The results from those “profit” regressions are marked reported after each indicator name as (+) or (-) and indicate whether a CSR indicator had a significant positive or negative effect on profits. The “profit” regressions are specified as follows:

$$ROA_{jt} = \alpha_t + \alpha_j + CSR_{jt-1} + X_{jt} + \zeta_{jt}$$

where ROA_{jt} are returns on assets for firm j in year t , α_t and α_j are time and firm fixed effects, CSR_{jt-1} is the firm’s social rating a year before, X_{jt} includes controls such as log assets controlling for firm size and the number of manager protection in place last year, and ζ_{jt} denotes an error term. I run one of these regressions for each indicator. The results of all 33 regressions are summarized in Table 2.

Table 2: Profitability Regressions – Returns on Assets projected on a CSR indicator and controls

Dependent Variable:	Return on Assets	
Lagged CSR Variable	CSR Coefficients	Standard Errors
	COMMUNITY	
Charitable Giving (I)	-0.00194	(0.0029)
Innovative Giving (I)	-0.00232	(0.0035)
Support for Housing (I)	-0.00412*	(0.0030)
Support for Education (I)	-0.0114***	(0.0057)
Investment Controversies (II)	0.00782***	(0.0037)
Negative Economic Impact (?)	0.00380	(0.0043)
Tax Disputes (I)	0.0103*	(0.0078)
	ENVIRONMENT	
Beneficial Products and Services (II)	-0.00614	(0.0060)
Pollution Prevention (I)	-0.00871***	(0.0044)
Recycling (?)	0.00176	(0.0052)
Clean Energy (I)	-0.00213	(0.0042)
Communications (I)	-0.0127\$*	(0.0081)
Hazardous Waste (I)	0.00251	(0.0033)

Continued on next page ...

Table 2: ... CSR Profitability Regressions Continued

Dependent Variable:	Return on Assets	
Lagged CSR Variable	CSR Coefficients	Standard Errors
Regulatory Problems (I)	0.00382	(0.0031)
Substantial Emission (I)	-0.00455	(0.0045)
Agricultural Chemical (II)	-0.00346	(0.012)
Contributing to Climate Change (II)	-0.00452	(0.013)
DIVERSITY		
Minority Promotion (I)	-0.00261	(0.0051)
Board of Directors (I)	0.00308	(0.0031)
Work/Life Benefits (I)	-0.0000989	(0.0046)
Women & Minority Contracting (I)	0.00311	(0.0041)
Employment of the Disabled (I)	-0.00604	(0.0058)
Gay & Lesbian Policies (I)	-0.00642*	(0.0046)
Diversity Controversies (I)	-0.00100	(0.0044)
Non-Representation (II)	0.0111*	(0.0083)
EMPLOYEES		
Union Relations(I)	-0.0189***	(0.0083)
Cash Profit Sharing (?)	-0.00642**	(0.0039)
Employee Involvement (II)	0.00586*	(0.0040)
Retirement Benefits Strength (I)	0.00369*	(0.0025)
Poor Union Relations (I)	-0.00786*	(0.0053)
Health and Safety Concern (I)	-0.00607	(0.0070)
Workforce Reductions (II)	-0.00284	(0.011)
Retirement Benefits Concern (II)	-0.00150	(0.0052)

Each line represents the result of a individual regression. The categorization is marked in parentheses, (I) for type I indicator where the manager prefers a higher level of CSR relative to shareholders, (II) for a type II CSR indicator where managers prefer a relative lower level and (?) indicators which are not categorized into either group. Regressions controls are year dummies and firm fixed effects, log assets as size measure and lagged manager protection. Covering data from 1991 trough 2005. Clustered standard errors in parentheses; stars represent significance levels *** $p < 0.01$ ** $p < 0.05$, * $p < 0.1$ for a one sided test.

Thirteen of the CSR coefficients are significant and only two of those are not consistent with my ratings based on the CSR descriptions. “Major tax disputes” which I had categorized as type I based on the reasoning that it might be more important to shareholder to not have tax disputes and might not have much of a warm glow for the manager. The other exception is given by “(strong) retirement benefits” which I had considered to be a type I CSR, while the profit regression shows a positive correlation with profits.

Before discussing my main specification in more detail, I will briefly describe the variables I have constructed from the Compustat data. Return on assets (ROA) is calculated as income before extraordinary items (Compustat item 18) over assets (item 6). As a measure for firm size, I use the log assets (log of item 6). An alternative measure is given by market capitalization, which is calculated as common shares outstanding (item 25) times the closing price at the end of the fiscal year (item 199).

3.3 Empirical Methodology

The basic regression specification used to analyze the effect of weaker governance on the different dimensions of CSR can be defined as follows:

$$CSR_{jt} = \alpha_t + \underbrace{\alpha_s + \alpha_i}_{\text{or } \alpha_j} + \beta X_{jt} + \gamma MP_{jt-1} + \varepsilon_{jt} \quad (1)$$

where CSR_{jt} is the firm j 's performance score of some CSR measure, s indexes the state of incorporation of a company, t indexes time and i is the index for the firm's industry. α_t , α_s and α_i are year, state and industry dummies. X_{jt} is a vector of control variables such as firm size and returns. MP_{jt-1} are the manager protections in place in firm j in year $t-1$. ε_{jt} is an error term. Including year fixed effects allows controlling for common changes over time. The industry fixed effects control for industry specific heterogeneity of firms like specific advertising practices in some industries or different distances in the supply chain to the end consumer. This is particularly important since some of KLD's CSR indicators are very industry specific. State fixed effects additionally allow controlling for local economic differences or differences in other local governance regulation. For my main analysis of all 33 individual binary CSR indicators, I will use logit regression models given the binary nature of the dependent variables.

Every regression specification is estimated twice, once as a pooled specification controlling for industry and state effects with α_s and α_i , and once as a regression across time where I include firm fixed effects to control for unobserved time invariant firm heterogeneity. In the latter case α_s and α_i are not included and instead I will use firm specific dummies α_j

in my regression specification. Both specifications have their advantages and disadvantages. Although the firm fixed effect regression allow me to control for all unobserved characteristics, such as a firm’s internal culture or how qualified or harmonic the management team is, it leads to a loss of degrees of freedom and a loss of power for any test statistics. I also lose an enormous amount of data in these regressions as all firms that do not ever have a rating of one for a certain CSR indicator drop out. Therefore these regressions only identify the effect of manager protections among a subset of firms that have a rating change for a CSR at some point in time.

The cross sectional approach has the advantage of a much bigger sample set, but we don’t control for unobservable heterogeneity on the firm level. This specification, however, allows me to add additional time invariant firm level controls. Besides time dummies, firm size and instrumented returns, I also control for heterogeneity across different industries and for being incorporated in a different state. This will likely control for a big chunk of firm heterogeneity. I further cluster the standard errors from those regressions by firm ID to avoid a downward bias estimate of the variance due to the remaining heterogeneity.

In order to avoid simultaneity bias in my main regressions, where I define ROA as a control variable, I instrument for returns in a first stage regression. In the first stage, I project ROA onto all other (exogenous) variables in my main regression and the first three lags of ROA:

$$ROA_{jt} = \delta_t + \delta_j + \varphi X_{jt}^{(w/ROA)} + \phi_1 ROA_{jt-1} + \phi_2 ROA_{jt-2} + \phi_3 ROA_{jt-3} + \eta_{jt}$$

The fitted values for ROA from the above projection serve as instrumental variables for my second stage regression defined above in Equation 1, replacing the contemporaneous Returns on Assets variable.

4. RESULTS

I start by discussing the results from the aggregate CSR regressions which are summarized in Table 3. As mentioned above the aggregate approach is the standard in the CSR

literature. The top part of the table uses a pooled specification controlling for industry and state of incorporation effects as well as year specific effects. Each column represents the regression coefficients for a subset the variables of a regression using the according aggregated CSR category score as the dependent variable. By looking at these results, it appears as if manager protection has a positive effect on whether firms provide equal opportunity for minorities, but leads to worse outcomes for employees. This result is hard to reconcile as it would mean that when managers have more slack they care less for the average worker but increase their effort with respect to minority groups. These regressions find no effect of manager protections on environmental or community CSR outcomes. It is likely that the aggregation of heterogeneous indicators within the categories makes it very hard to understand and interpret to results properly. When running the disaggregated regressions, results show a positive effect on some employee benefits. The different results indicate that we should not rely on aggregated specifications.

The results of the firm fixed regressions in the bottom half of Table 3 paint a similar picture. We do not observe much of an effect of weak governance on the different CSR category scores. Only the coefficient in the environment regression is negative and significant. These results would suggest a general downturn in a firm’s environmental performance when managers have more freedom, which as we will see in the disaggregated regression is only half of the truth.

The inconsistencies in these results and my discussion in the previous section regarding the diversity of indicators underline the necessity of desegregation. The remainder of this section will focus on the results of the individual logit regressions. For each CSR indicator, I estimate a logit model as specified in Equation 1. Table 4 summarizes the results of these 66 individual logit regressions. The indicators, which represent the changing dependent variables, are ordered by category. In each category the strength indicators are followed by the category’s concern indicators separated by a double horizontal line.²⁴ I will go through the findings in the table by category’s. The first three columns of Table 4 present the regressions results from the pooled specification where we control for state of incorporation and indus-

²⁴This is done to distinguish concern indicators in each category more clearly form the strength indicators given the very different interpretation of results.

Table 3: Relation between aggregated CSR and manager protection

Variables	Community	Environmental Diversity	Employee Relations	
Regressions including year, state and industry fixed effects				
Manager Protection	-0.00419	-0.00701	0.0394**	-0.0271*
	(0.011)	(0.012)	(0.019)	(0.015)
Predicted Return on Assets	0.177	0.302**	0.633**	2.411***
	(0.13)	(0.14)	(0.28)	(0.37)
Log Assets	0.114***	-0.105***	0.369***	0.0437***
	(0.014)	(0.016)	(0.022)	(0.015)
Observations	11960	11957	11960	11960
Number of firms	2135	2135	2135	2135
R-squared	0.28	0.36	0.36	0.20
Regressions including year and firm fixed effects				
Manager Protection	0.0121	-0.0501*	0.0463	-0.00910
	(0.020)	(0.029)	(0.036)	(0.031)
Predicted Return on Assets	-0.109	-0.0204	0.0154	0.976***
	(0.11)	(0.13)	(0.30)	(0.37)
Log Assets	0.0751**	-0.145***	0.199***	0.0921**
	(0.031)	(0.050)	(0.056)	(0.044)
Observations	11960	11957	11960	11960
Number of firms	2135	2135	2135	2135
R-squared	0.03	0.02	0.17	0.06

The dependent variables are KLD category scores. All regressions include year dummies. The regressions in the first part of the table include as further controls state dummies and 3 digit industry dummies. Regressions in the second part of the table include firm fixed effects. The coefficient and standard error for the constant term are suppressed. The data is for 1991 through 2005. Standard errors in parentheses are clustered by firms; stars represent significance levels *** p<0.01, **p<0.05, * p<0.1

try fixed effects. Columns four through six present the according results for each indicator where the logit regressions are specified as cross time regressions using firm fixed effects. For each regression we report the main coefficient of interest on management protection, the number of firm-year observations included in the regression, number of firms as well as the log likelihood value and the regressions' pseudo R².

Table 4: Main Results – Logit Regressions of Individual CSR Indicators on Manager Protection

Year, State and Industry FE				Year and Firm FE		
Manager Protection (s.e.)	Number of Observations [Firms]	Log Likelihood [Pseudo R ²]	Likelihood	Manager Protection (s.e.)	Number of Observations [Firms]	Log Likelihood [Pseudo R ²]
COMMUNITY						
Charitable Giving (I) Notably generous, s.a. giving 1.5% of net earnings						
0.039 (0.075)	8357 [1396]	-2023 [0.21]		0.144 (0.111)	2195 [188]	-841.3 [0.04]
Innovative Giving (I) Giving to NGOs, promoting self sufficiency, permitting giving drives in work-place						
0.053 (0.086)	7471 [1287]	-1613 [0.36]		-0.189 (0.144)	1581 [133]	-569.2 [0.12]
Support for Housing (I)(-) Prominent participant in partnerships supporting housing						
0.156* (0.089)	6495 [1127]	-1748 [0.33]		0.181 (0.127)	1527 [153]	-595.8 [0.08]
Support for Education (I)(-) Notably innovative support, job-training program for youth						
0.167* (0.098)	5881 [1141]	-1389 [0.39]		0.213 (0.167)	1062 [108]	-409 [0.08]
Investment Controversies (II)(+) Lending or investment led to controversies						
-0.111 (0.125)	2478 [560]	-494 [0.39]		-0.72*** (0.249)	558 [76]	-185 [0.18]
Negative Economic Impact (?) Major controversies, s.a. contamination, water rights dispute						
0.353*** (0.100)	5733 [1041]	-1061 [0.37]		0.110 (0.146)	1356 [116]	-431 [0.27]
Tax Disputes (I)(+) Major tax disputes with authorities						
0.255** (0.124)	5654 [979]	-748 [0.39]		0.077 (0.183)	1095 [106]	-318 [0.22]

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Table 4: ... Logit Regression Results Continued

Year, State and Industry FE			Year and Firm FE		
Manager Protection (s.e.)	Number of Observations [Firms]	Log Likelihood [Pseudo R ²]	Manager Protection (s.e.)	Number of Observations [Firms]	Log Likelihood [Pseudo R ²]
ENVIRONMENT					
Beneficial Products and Services (II) Substantial revenues from environmental products or services					
0.072 (0.117)	3659 [550]	-916 [0.29]	-1.115*** (0.269)	799 [68]	-261.4 [0.18]
Pollution Prevention (I)(-) Notably strong pollution prevention programs					
0.100 (0.107)	5422 [902]	-1057 [0.32]	0.255* (0.145)	1325 [103]	-539.3 [0.03]
Recycling (?) Substantial user of recycled material, major factor in recycling industry					
0.000 (0.138)	3494 [545]	-661 [0.42]	0.297 (0.242)	687 [57]	-242.7 [0.04]
Clean Energy (I) Significant use of renewable energy, commitment outside its operations					
0.261** (0.11)	5178 [898]	-927 [0.53]	0.153 (0.14)	1177 [113]	-428.7 [0.02]
Communications (I)(-) Substantive environmental report, internal communication CERES principles					
0.369* (0.197)	2393 [683]	-421 [0.41]	-0.695* (0.403)	318 [44]	-108.2 [0.15]
Hazardous Waste (I) Liabilities for Hazardous waste >\$50 million, substantial fines					
0.239*** (0.081)	6806 [1131]	-1641 [0.51]	0.141 (0.115)	1700 [146]	-600.2 [0.10]
Regulatory Problems (I) Substantial fines for violation of environmental regulation					
0.153** (0.067)	7495 [1294]	-2035 [0.42]	0.443*** (0.105)	2427 [218]	-887.5 [0.10]
Substantial Emission (I) Emissions highest among all companies					
0.077 (0.075)	6384 [1110]	-1446 [0.42]	-0.036 (0.106)	1977 [180]	-703.4 [0.12]
Agricultural Chemical (II) Substantial producer of agricultural chemicals					
0.050 (0.219)	1192 [191]	-227.9 [0.53]	-0.054 (0.293)	212 [18]	-77 [0.15]

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Table 4: ... Logit Regression Results Continued

Year, State and Industry FE			Year and Firm FE		
Manager Protection (s.e.)	Number of Ob- servations [Firms]	Log Likelihood [Pseudo R ²]	Manager Protection (s.e.)	Number of Ob- servations [Firms]	Log Likelihood [Pseudo R ²]
Contributing to Climate Change (II) Substantial revenues from sale or indirect combustion of fuel					
-0.077 (0.160)	1074 [253]	-426.8 [0.41]	-0.021 (0.513)	155 [28]	-55 [0.12]
DIVERSITY					
Promotion (I) Notable progress in promotion of women and minorities					
0.027 (0.040)	11078 [1944]	-5232 [0.16]	0.141** (0.071)	5018 [533]	-1984 [0.07]
Board of Directors (I) Women or minorities hold > 4 seats or 1/3 of less then 12 seats					
0.173** (0.070)	8538 [1428]	-2413 [0.28]	0.112 (0.117)	2739 [257]	-742.9 [0.36]
Work/Life Benefits (I) Outstanding employee benefits e.g. childcare, flextime					
0.115 (0.085)	7777 [1395]	-2191 [0.37]	0.302 (0.187)	1674 [144]	-432.8 [0.40]
Women & Minority Contracting (I) Strong record of purchasing or contracting with minority owned business					
0.104 (0.088)	7443 [1257]	-1521 [0.34]	-0.042 (0.117)	1816 [149]	-627.2 [0.16]
Employment of the Disabled (I) Superior reputation as employer of disabled					
0.057 (0.096)	5831 [1034]	-813.2 [0.40]	0.023 (0.140)	1192 [94]	-389.6 [0.15]
Gay & Lesbian Policies (I)(-) Notably progressive policies for gay and lesbian employees					
0.226*** (0.065)	8052 [1695]	-2333 [0.39]	0.530*** (0.200)	2944 [370]	-355 [0.72]
Diversity Controversies (I) Paid substantial fine or major involvement in affirmative action controversy					
-0.020 (0.074)	8306 [1484]	-1807 [0.29]	-0.153 (0.117)	2170 [209]	-709 [0.20]
Non-Representation (II)(+) No women on Board or among senior managers					
-0.172*** (0.051)	10206 [1996]	-3911 [0.23]	-0.129 (0.119)	3400 [547]	-1001 [0.22]
EMPLOYMENT RELATIONS					

Continued on next page ...

Table 4: ... Logit Regression Results Continued

Year, State and Industry FE			Year and Firm FE		
Manager Protection (s.e.)	Number of Ob- servations [Firms]	Log Likelihood [Pseudo R ²]	Manager Protection (s.e.)	Number of Ob- servations [Firms]	Log Likelihood [Pseudo R ²]
Union Relations(I)(-) Exceptional effort to treat union workforce fairly					
0.447* (0.259)	1384 [216]	-220.7 [0.44]	1.216*** (0.382)	210 [18]	-73.78 [0.20]
Cash Profit Sharing (?)(-) Cash profit sharing program for majority of workforce					
0.029 (0.070)	8827 [1515]	-2975 [0.21]	0.227** (0.110)	2158 [202]	-873.5 [0.04]
Employee Involvement (II)(+) Strongly encourages worker involvement and ownership					
-0.093 (0.060)	9153 [1587]	-3484 [0.17]	0.030 (0.102)	2595 [256]	-1000 [0.11]
Retirement Benefits Strength (I)(+) Notably strong retirement benefits					
-0.004 (0.075)	7895 [1360]	-2080 [0.18]	-0.153 (0.100)	2259 [214]	-855.3 [0.04]
Poor Union Relations (I)(-) History of notably poor union relationship					
0.067 (0.106)	5603 [865]	-1047 [0.29]	0.063 (0.131)	1139 [100]	-420.7 [0.06]
Health and Safety Concern (I) Paid substantial fine or major health and safety controversies					
0.047 (0.089)	6808 [1157]	-1209 [0.31]	0.118 (0.137)	1711 [159]	-531 [0.15]
Workforce Reductions (II) Significant reduction in workforce in recent years					
0.077 (0.060)	8829 [1568]	-2135 [0.23]	0.053 (0.122)	2303 [282]	-719.8 [0.18]
Retirement Benefits Concern (II) Inadequate or under funded retirement program					
0.028 (0.040)	11091 [2055]	-4440 [0.16]	-0.200** (0.089)	5637 [701]	-1550 [0.30]

These are logit regression where the dependent variables are KLD indicators. The categorization is marked in parentheses, (I) for type I indicator where the manager prefers a higher level of CSR relative to shareholders, (II) for a type II CSR indicator where managers prefer a relative lower level and (?) indicators which are not categorized into either group. Regressions also include a constant, an instrument for returns on assets, logged assets and year dummies as well as either state dummies and 3 digit industry dummies in the left column or firm dummies in right column. The data is for 1991 through 2005. Standard errors in parentheses are clustered by firms; stars represent significance levels *** p<0.01, ** p<0.05, * p<0.1.

In the first category in Table 4, Community Relations, we find that although there is no significant effect of manager protection on charitable giving or innovative giving, manager

protection has a positive significant effect on a firm's performance for support of housing and support for education. I will connect the findings in this category directly to my hypotheses to help understand how my theory integrates with my empirical analysis. Both my categorization and the profit regression suggest that housing and education indicators are type I CSRs. The increase of these CSR indicators under slack governance follows the predictions of my theory and support hypothesis I. I further find a strong negative effect of weak governance on investment controversies, which means that firms have fewer investment controversies in the community when managers have more slack. According to both methods of categorization "investment controversies" are a type II CSR and so we expect to see a downward shift in the indicator. This results is therefore also in support of hypothesis I. The last two concern indicators in the Community Relations category indicate that managers with more protection from shareholders tend to neglect their tax duties, but also assert more negative externalities on the community such as an environmental contamination or water right disputes. While I categorize the negative economic impact as ambiguous given the diverse issues mentioned in the description that enter into the rating, I categorize the tax duties as a type I CSR, which according to my theory predicts the observed increase in the indicator under a weakening in corporate governance.

The last finding is similar to what we see in the Environmental Concerns category, a neglect of the firm's core duties such as complying with environmental regulations. A manager that is more entrenched in the firm will incur more fines and penalties for both hazardous waste and pollution offences. This result is especially strong as it is consistent looking across firms and also across time when including firm fixed effects. Although managers with more slack behave recklessly with regards to the environment by neglecting core duties, they also engage in proactive pollution prevention. Firms with more protections for managers do also commit themselves to clean energy policies even outside their own operations. The CSR indicator for Environmental Communication shows how different the identification for the effect of manager protections can be in cross-section from the firm fixed effect regression. While we find a positive correlation with protections in accordance with my hypothesis in the pooled regression, looking at the small sub-sample of firms that have had a change in this CSR rating, we find a negative correlation. As the sample in the fixed effect regressions

is reduced, we identify the effect of changes in corporate governance using far fewer firms. The effect is particularly strong for this indicator, as the total number of observations is rather small to start with. The variable has only half the observations in addition to a very exclusive rating in which only 3% of all firms get rated as one. This reduces the number of firms the manager protection coefficient in the fixed effect regression is identified off to only 44, which makes the regression results less robust to individual firm influences. The results on beneficial products and services show a case where in accordance with my hypothesis II managers neglect a type II CSR. Further, we find as we would expect that managers' freedom has no effect on firms' core businesses such as producing agricultural chemicals or selling oil and gas. These are screening indicators as they evaluate what firms business is and not how they conduct it. We see a great deal of diversity among indicators in this category, which makes a strong case for disaggregation. When we compare these disaggregated results to the negative coefficient in the aggregate environmental regression in Table 3 we see that the effect of management protections on environmental performance can be greatly distorted by the aggregation of heterogeneous indicators.

The Diversity Issue section consists of much more homogenous indicators. Across indicators, we find that managers with weak governance support minorities. This is in accordance with my theory as diversity types of CSR do not generate a big return to shareholders but give managers a warm glow; therefore, managers will have a preference for relatively higher support for minorities as stated in hypothesis I. This also explains why we saw a significant positive effect using the aggregated measure of diversity CSR, as indicators in this area are much more homogenous. I find that entrenched managers promote more women and minorities in positions of responsibility and support progressive policies for gay and lesbian workers. Firms with more manager protections also have more women on the board of directors and in top management.

Among Employee Relations indicators we find a general increase in support for worker interests under weaker governance. Managers have better union relationships, which is in accordance with hypothesis I and supports the findings by that managers do more for their workers when they have more protections in place. I also observe more profit sharing with workers. This is in support of my theory since it is a type I CSR according to the profit

regression, where I find a negative effect of profit sharing with next period's accounting profits. The very last result of Table 4 suggests that managers increase efforts in retirement benefits programs when profit constraints are relaxed. This finding gives further support for my first hypothesis – judged by KLD's description of the indicator, more benefits are not in the interest of shareholders.

Overall, I find strong support in favor of my hypotheses which validates my theory. Out of all 33 indicators, we find significance for 18, of which only one is not in accordance with my hypotheses and the categorization based on KLD's description. The deviating indicator is the negative effect of manager protections on the Environmental Communications CSR. As I pointed out earlier, this result from my firm fixed effect logit regression is only identified by possible changes induced by manager protections in 44 firms.

If I employ the data for a categorization into type I and type II CSRs running separate profit regressions and then compare the results with the findings, I again have strong support for my theory. Only two indicators categorized by the profit regressions are affected conversely to what my hypotheses predict. Communication in the firm fixed effects specification is negatively affected although the CSR indicator has a negative correlation with profits. Tax disputes are positively correlated with future accounting profits, suggesting that it is a type II CSR, in which shareholders desire relatively more of it than managers. And even though it is classified as a type II CSR we observe an increase in tax disputes for firms with weaker governance.

When I shift to Graham Bullocks classification the support becomes much weaker. He rates Tax Disputes, Environmental Regulatory Problems and Gay & Lesbian Policies as a type II CSR. Since these coefficients are significantly positive they go against our theory. Partly the support for the theory also vanishes as Bullock categorizes many more CSR indicators as ambiguous, see Table 6 in Appendix C.

The overview in Table 5 presents the pooled regression results in terms of support for our theory. It shows the results for the categorization according to the KLD description, the categorization based on the data via the profitability regression and the categorization by the independent rater. For our indicator categorization we find that 24 out of 30 coefficients have the correct sign and of the 11 significant coefficients all have the predicted sign. When

Table 5: Overview of Empirical Results Support of Theory by Categorizations – Pooled Regressions

	Category:	Type I	Type II	Total	Ambiguous
Categorization based on KLD description	All	20/21	4/9	24/30	3
	Significant	10/10	1/1	11/11	1
Data based Categorization	All	8/8	4/5	12/13	20
	Significant	5/5	1/2	6/7	5
Independent Rater's Categorization	All	9/13	3/7	12/20	13
	Significant	2/5	1/1	3/6	6

Each entry in the table shows out of the total number of indicators in each category (first row) how many indicator coefficients based on the different categorizations (first column) have the sign as predicted by my theory. This is done for each categorization for all 33 indicators and for all the indicator coefficients that are significant at the 10% level in the pooled regression.

looking at the data driven categorization we find 12 out of the 13 non ambiguous indicators have the expected sign and 6 out of 7 when only looking at the significant indicators. the last two rows in Table 5 show the results according to Bullock's ratings. We find that 12 out of 20 indicator coefficients have the expected sign and 3 of 6 when looking at the significant coefficients. The large difference in support for the theory of the independent raters categorizations is partially due to him rating 10 more indicators as ambiguous. The results of the cross time regression are very similar. I report these in the same way in Table 7 in Appendix C.

As pointed out earlier, reverse causality has been a valid concern in the literature on CSR. To check for this issue in my data with regards to takeover defenses, I run 33 regressions (not reported here) where I reverse the role of ATPs and CSRs. Manager protection is the dependent variable and the explanatory variables are lagged CSR together with firm size, predicted return on assets, year and firm fixed effects. None of the CSR coefficients is significantly different from zero in any of the 33 regressions which leads me to conclude with confidence that there is no causal effect of CSR on the implementation of anti-takeover provisions.

5. SUMMARY AND CONCLUSION

The separation of ownership from control in modern corporations leads to a potential conflict of interest for the manager of the firm. A manager is hired to represent the interest of the shareholders of the firm but also has his own preferences and goals he would like to pursue. Corporate governance mechanisms try to align the incentives of both parties. Recent scandals in big firms like Enron, WorldCom and Tyco International have put the topic of corporate governance back at the top of politicians', administrators' and managements' agendas. The Sarbanes–Oxley Act of 2002 aims to strengthen corporate governance as a result of these scandals and is currently being implemented by the Securities and Exchange Commission. In my research, I examine the potential effects of changes in governance on non-financial firm outcomes in the social and environmental domain. I infer managers' preferences from the response of corporate social performance to changes in takeover defenses. A better understanding of managers' preferences is important to integrate the corporate governance debate into the broader fields of compliance and enforcement of regulation, corporate philanthropy and corporate citizenship.

I develop a “good life” theory of managers' preferences, building on the findings in psychology that people increase their subjective well-being by contributing to the greater good. My theory extends the “quiet life” theory of that managers simply try to avoid difficult decisions and costly efforts. I argue that the cognitive life satisfaction or “warm glow” which managers get from implementing social and environmental programs motivates them to spend more of the firm's resources and put in more personal effort. Thus, social responsibilities which are relatively unprofitable will receive more attention by managers when the profitability constraint of the firm is relaxed by an increase in governance slack. My theory also implies that a manager's core duties will be more often neglected when he is protected from shareholders. This holds true even if they incorporate positive social or environmental aspects.

Employing a unique dataset, I test whether my findings provide support for this theoretical framework. I find that managers increase benefits to workers when they are more protected from shareholders, as both the “good life” and the “quiet life” theory would

predict. The data also confirms that managers with more slack tend to neglect core duties such as compliance with pollution regulations. This is consistent with managers' preference to avoid costly efforts. Additionally, my results show that managers under weaker governance put more voluntary effort into the environment, give more money to charity, and support women and minorities in the work force. These results support my hypothesis that top managers implement higher levels of socially responsible corporate programs once they are more entrenched, which in turn reflects their social and environmental preferences.

In terms of the debate on the overall effect of takeover preventions, my results support the view that anti-takeover provisions lead to entrenchment of management in ways that are costly from the shareholders perspective. More resources are allocated to social and environmental projects with ambiguous benefits on shareholder value, while some unambiguously important manager duties are neglected.

In this study I also highlight the problems that arise when using aggregated corporate social responsibility data, as is common practice in the existing literature. I show that it is essential to look at individual indicators, especially when studying the causes and effects of corporate social and environmental outcomes.

Finally, my study sets the stage for future work. The longitudinal data on corporate social responsibility and the disaggregated methodology could prove fruitful in reassessing earlier studies of the causes and effects of corporate social responsibility. In light of my results on pollution violations, future studies should look at the effects of corporate governance on compliance in different fields of regulation. Results from such studies could provide additional guidance for the design of regulation enforcement and policy rules on corporate governance.

A. KLD INDICATOR DESCRIPTIONS

Behind each indicator name in parentheses is the classification into type I or type II CSR. If an indicator is of type II, the shareholders prefer a higher level of CSR relative to the manager; in other words it is more profit-oriented than warm-glow giving. A CSR outcome for which the manager prefers a higher level of CSR relative to the shareholders, is marked with (I). For indicators marked (?) it was ambiguous if the manager or shareholder preferred a higher level of CSR given the description. I also note if for a given indicator there is significantly less than full availability of data. The description will say (L) for less data if the indicator has less but still more than half the full observations. It will say (LL) if we have less than half the complete observations for an indicator and it will say (LLL) if there are very few observations, less than 20% of the full set. I indicate an indicator which has complete or close to complete data with (F).

COMMUNITY

STRENGTHS

Charitable Giving A (F)(I). The company has consistently given over 1.5% of trailing three year net earnings before taxes (NEBT) to charity, or has otherwise been notably generous in its giving.

Innovative Giving B (F)(I). The company has a notably innovative giving program that supports nonprofit organizations, particularly those promoting self-sufficiency among the economically disadvantaged. Companies that permit nontraditional federated charitable giving drives in the workplace are often noted in this section as well.

Non-US Charitable Giving F (LLL)(I). The company has made a substantial effort to make charitable contributions abroad, as well as in the U.S. To qualify, a company must make at least 20% of its giving, or have taken notably innovative initiatives in its giving program, outside the U.S.

Support for Housing C (L)(I). The company is a prominent participant in public/private partnerships that support housing initiatives for the economically disadvantaged, *e.g.*, the National Equity Fund or the Enterprise Foundation.

Support for Education D (L)(I). The company has either been notably innovative in its support for primary or secondary school education, particularly for those programs that benefit the economically disadvantaged, or the company has prominently supported job-training programs for youth. In 1994, KLD added the Support for Education Strength.

Volunteer Programs G (LL)(?). The company has an exceptionally strong volunteer program. In 2005, KLD added the Volunteer Programs Strength.

Other Strength X (F). The company has either an exceptionally strong in-kind giving program or engages in other notably positive community activities.

CONCERNS

Investment Controversies A (F)(II). The company is a financial institution whose lending or investment practices have led to controversies, particularly ones related to the Community Reinvestment Act.

Negative Economic Impact B (F)(?). The company's actions have resulted in major controversies concerning its economic impact on the community. These controversies can include issues related to environmental contamination, water rights disputes, plant closings, "put-or-pay" contracts with trash incinerators, or other company actions that adversely affect the quality of life, tax base, or property values in the community.

Tax Disputes D (LL)(I). The company has recently been involved in major tax disputes involving Federal, state, local or non-U.S. government authorities, or is involved in controversies over its tax obligations to the community. In 2005, KLD moved Tax Disputes from Corporate Governance to Community.

Other Concern X (F). The company is involved with a controversy that has mobilized community opposition, or is engaged in other noteworthy community controversies.

ENVIRONMENT

STRENGTHS

Beneficial Products and Services A (F)(II). The company derives substantial revenues from innovative remediation products, environmental services, or products that promote the efficient use of energy, or it has developed innovative products with environmental benefits. (The term

“environmental service” does not include services with questionable environmental effects, such as landfills, incinerators, waste-to-energy plants, and deep injection wells.)

Pollution Prevention B (F)(I). The company has notably strong pollution prevention programs including both emissions reductions and toxic-use reduction programs.

Recycling C (F)(?). The company either is a substantial user of recycled materials as raw materials in its manufacturing processes, or a major factor in the recycling industry.

Clean Energy D (F)(I). The company has taken significant measures to reduce its impact on climate change and air pollution through use of renewable energy and clean fuels or through energy efficiency. The company has demonstrated a commitment to promoting climate-friendly policies and practices outside its own operations. KLD renamed the Alternative Fuels strength as Clean Energy Strength.

Communications E (L)(I). The company is a signatory to the CERES Principles, publishes a notably substantive environmental report, or has notably effective internal communications systems in place for environmental best practices. KLD began assigning strengths for this issue in 1996, and then incorporated the issue with the Corporate Governance: Transparency rating (CGOV-str-D), which was added in 2005. In all spreadsheets it is incorporated into the Transparency rating.

Property, Plant, and Equipment F (LLL)(I). The company maintains its property, plant, and equipment with above average environmental performance for its industry. KLD has not assigned strengths for this issue since 1995.

Other Strength X (F). The company has demonstrated a superior commitment to management systems, voluntary programs, or other environmentally proactive activities.

CONCERNS

Hazardous Waste A (F)(I). The company’s liabilities for hazardous waste sites exceed \$50 million, or the company has recently paid substantial fines or civil penalties for waste management violations.

Regulatory Problems B (F)(I). The company has recently paid substantial fines or civil penalties for violations of air, water, or other environmental regulations, or it has a pattern of regulatory controversies under the Clean Air Act, Clean Water Act or other major environmental regulations.

Ozone Depleting Chemicals C (F)(?). The company is among the top manufacturers of ozone depleting chemicals such as HCFCs, methyl chloroform, methylene chloride, or bromines.

Substantial Emissions D (F)(I). The company's legal emissions of toxic chemicals (as defined by and reported to the EPA) from individual plants into the air and water are among the highest of the companies followed by KLD.

Agricultural Chemicals E (F)(II). The company is a substantial producer of agricultural chemicals, *i.e.*, pesticides or chemical fertilizers.

Climate Change F (L)(II). The company derives substantial revenues from the sale of coal or oil and its derivative fuel products, or the company derives substantial revenues indirectly from the combustion of coal or oil and its derivative fuel products. Such companies include electric utilities, transportation companies with fleets of vehicles, auto and truck manufacturers, and other transportation equipment companies. In 1999, KLD added the Climate Change Concern.

Other Concern X (F). The company has been involved in an environmental controversy that is not covered by other KLD ratings.

DIVERSITY

STRENGTHS

CEO A (F)(?). The company's chief executive officer is a woman or a member of a minority group.

Promotion B (F)(I). The company has made notable progress in the promotion of women and minorities, particularly to line positions with profit-and-loss responsibilities in the corporation.

Board of Directors C (F)(I). Women, minorities, and/or the disabled hold four seats or more (with no double counting) on the board of directors, or one-third or more of the board seats if the board numbers less than 12.

Work/Life Benefits D (F)(I). The company has outstanding employee benefits or other programs addressing work/life concerns, *e.g.*, childcare, elder care, or flextime. In 2005, KLD renamed this strength from Family Benefits Strength.

Women & Minority Contracting E (F)(I). The company does at least 5% of its subcontracting, or otherwise has a demonstrably strong record on purchasing or contracting, with women and/or minority-owned businesses.

Employment of the Disabled F (F)(I). The company has implemented innovative hiring programs; other innovative human resource programs for the disabled, or otherwise has a superior reputation as an employer of the disabled.

Gay & Lesbian Policies G (F)(I). The company has implemented notably progressive policies toward its gay and lesbian employees. In particular, it provides benefits to the domestic partners of its employees. In 1995, KLD added the Gay & Lesbian Policies Strength, which was originally titled the Progressive Gay/Lesbian Policies strength.

Other Strength X (F). The company has made a notable commitment to diversity that is not covered by other KLD ratings.

CONCERNS

Controversies A (F)(I). The company has either paid substantial fines or civil penalties as a result of affirmative action controversies, or has otherwise been involved in major controversies related to affirmative action issues.

Non-Representation B (F)(II). The company has no women on its board of directors or among its senior line managers.

Other Concern X (F). The company is involved in diversity controversies not covered by other KLD ratings.

EMPLOYEE RELATIONS

STRENGTHS

Union Relations A (F)(I). The company has taken exceptional steps to treat its unionized workforce fairly. KLD renamed this strength from Strong Union Relations.

No-Layoff Policy B (LLL)(I). The company has maintained a consistent no-layoff policy. KLD has not assigned strengths for this issue since 1994.

Cash Profit Sharing C (F)(?). The company has a cash profit-sharing program through which it has recently made distributions to a majority of its workforce.

Employee Involvement D (F)(II). The company strongly encourages worker involvement and/or ownership through stock options available to a majority of its employees; gain sharing, stock ownership, sharing of financial information, or participation in management decisionmaking.

Retirement Benefits Strength F (L)(I). The company has a notably strong retirement benefits program. KLD renamed this strength from Strong Retirement Benefits.

Health and Safety Strength G (LLL)(II). The company has strong health and safety programs.

Other Strength X (F). The company has strong employee relations initiatives not covered by other KLD ratings.

CONCERNS

Union Relations A (F)(I). The company has a history of notably poor union relations. KLD renamed this concern from Poor Union Relations.

Health and Safety Concern B (F)(I). The company recently has either paid substantial fines or civil penalties for willful violations of employee health and safety standards, or has been otherwise involved in major health and safety controversies.

Workforce Reductions C (F)(II). The company has made significant reductions in its workforce in recent years.

Retirement Benefits Concern D (F)(II). The company has either a substantially underfunded defined benefit pension plan, or an inadequate retirement benefits program. In 2004, KLD renamed this concern from Pension/Benefits Concern.

Other Concern X (F). The company is involved in an employee relations controversy that is not covered by other KLD ratings.

B. EXTRA TABLES

Table 6: Differences and Commonalities between Categorizations

Independent Raters Categorization Our Categorization	Same Type	Ambiguous	Opposite Type
Type I	10	7	5
Type II	5	3	0
Ambiguous	3	0	0
Total	18	10	5

Table 7: Overview of Empirical Results Support of Theory by Categorizations – Cross Time Effect Regressions

		Type I	Type II	Total	Ambiguous
Categorization based on KLD description	All	17/21	6/9	23/30	3
	Significant	5/6	3/3	8/9	1
Data based Categorization	All	7/8	3/4	10/13	20
	Significant	4/5	1/1	5/6	4
Independent Rater's Categorization	All	6/10	5/10	11/20	13
	Significant	1/2	1/3	2/5	5

Each entry in the table shows out of the total number of indicators in each category (first row) how many indicator coefficients based on the different categorizations (first column) have the sign as predicted by my theory. This is done for each categorization for all 33 indicators and for all the indicator coefficients that are significant at the 10% level in the cross time regression.

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