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Corporate Sustainability Performance: Constructs, Measures and Investors' Responses

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Executive Summary

This thesis aims at analyzing the fundamental question of how corporate sustainability performance can be evaluated and how economic decision makers, like investors, react to corporate sustainability performance information.

This thesis can be divided into three parts. **Part One** focuses on how corporate sustainability performance has been defined. But also to the contribution of companies to sustainable development and the opportunities and dilemmas companies are facing in this respect.

In chapter two, the following twelve constructs articulating the business-society relationship are described and analyzed on the basis of three criteria:
Corporate social responsibility; Corporate social responsiveness; Social Issues Management; Corporate social performance; Sustainable development; Corporate Sustainability; Business Ethics; Corporate Social Policy Process; Sustainable Corporate Performance; Stakeholder Management; Consultation and Dialogue; Corporate Citizenship and Triple-Bottom-Line
These constructs are analyzed using the following criteria:
Construct convergence refers to the extent to which a specific construct is unambiguously defined throughout relevant literatures. If a specific construct is defined or applied identically by different authors, then the construct is qualified as convergent. If, on the other hand, a construct is interpreted differently by different authors, the construct is qualified as divergent.
Construct categorization refers to a classification on the basis of the so-called Donaldson and Preston typology (Donaldson and Preston, 1995). According to this typology a construct can be descriptive, instrumental or normative.
Level of analysis refers to the level of analysis that is central to the business-society construct. Following Clarkson (1995) business-society relationships can be described and analyzed at three levels: the individual, organizational and societal level.
Most of these twelve constructs are not unequivocally defined, described and/or interpreted. The ambiguity may be the result of construct evolution or definitional chaos. Also, most constructs are normatively framed. That is, these constructs somehow challenge the idea that the only responsibility of companies is to increase profits and to serve the interests of their shareholders. Companies should also take the interests of all stakeholders, the (natural) environment and society at large into account. Although normatively framed, in their application many of these constructs are descriptive or instrumental. Also, most of the constructs are organization centered.

In chapter 3 we see that business has made substantial contributions to sustainable development. Unfortunately, these contributions have been more than offset by factors that are beyond control of the business community. For example, business has increased the energy efficiency of its production processes. These effects have been more than offset by an increasing world population and increasing individual prosperity levels. However, in an early contribution, Von Weizsäcker, Lovins and Lovins (1997) already provided the insight that at least four times as much wealth could be extracted from the resources currently used if all available options (technologies and products) to do so are embraced. The question is, whether this will be enough, or if a fundamental transition is required to achieve a state of sustainable development.
Increasing energy efficiency serves business' self-interest, because it has a positive effect on profitability and is welcomed by shareholders. However, it is also applauded by other stakeholders, albeit for different reasons. Protecting the environment –for example by reducing CO_2 emissions-beyond what is legally required is not in the interest of business. To overcome this problem governments and international authorities have to play an active role in protecting the environment. Furthermore, companies cannot be held responsible for alleviating all social misery at a global scale. Social issues are mainly the domain of governments and international authorities. (quasi) collective goods, such as education, health care and clean drinking water are usually provided by local, national and international governments and authorities and not by companies. Companies focus on their stakeholders and balance their interests.

We can distinguish four arguments for business to contribute to sustainable development.

- *Stakeholder pressures and expectations*. It is argued that, any social institution (organization) – and business is no exception - operates in society via a social contract, expressed or implied. Investors, employees, customers, governments, non/governmental organizations, etcetera- exert pressures on companies to conform to their norms, values and expectations. Non-compliance may ultimately jeopardize a company's legitimacy and hence its survival and growth.

- *Competitive advantage*. A company's competitive advantage is determined by its resources and capabilities (Barney, 1991). Resources are the assets that a firm owns. These assets may be tangible or intangible. Companies can enjoy a sustained competitive advantage if they possess resources that are valuable, non-substitutable, rare, difficult to replicate, tacit and socially complex (Hart, 1995). Capabilities on the other hand, are the capacity for a team of resources to perform some task or activity. In essence, a capability can be seen as a routine or a number of (interacting) routines in various fields (Grant, 1991)
- *Financial performance*. Since the early 1970s a plethora of studies accentuating the corporate sustainability performance-financial performance link have been conducted. So far we have not been able to give an unambiguous and straightforward answer to the question as to whether corporate sustainability performance pays off. However, more important than the question 'does corporate sustainability performance pay?' would be the question 'when does corporate sustainability performance pay?'
- *Ethics* is about unconditionally doing the right thing, because doing the right thing is the only right thing to do, and expresses moral commitment. A good deal of the corporate sustainability performance constructs discussed in chapter two assume that corporate sustainability performance and economic performance are distinct realms (Freeman, 1994) which are based on different values. However, companies will act ethically because and as long as it is in their interest to do so. But even if ethical performance does not contribute to profitability, ethical performance is still constrained by the financial bottom-line. In the extreme, a company cannot behave ethically for a long period of time beyond the point where the costs of behaving ethically exceed a company's revenues from ordinary business activities. In that situation the costs of behaving ethically would threaten a company's survival.

Based on these arguments we can distinguish three interacting clusters of stakeholders. Each cluster emphasizing specific expectations:

- *Shareholders*, who expect and pressure companies to maximize profitability/market value.
- *Other primary stakeholders* (especially customers, employees, suppliers, etcetera) who expect and/or pressure companies to be committed to sustainable development.
- *Secondary stakeholders* who represent society (including government). These groups have the capability to pressure companies to live up to societal norms and values. Not living up to these norms may ultimately jeopardize a company's legitimacy.

Although we have been able to distinguish clusters of stakeholders, each with a specific focus, we still have gained no insight into the issues reflecting stakeholder pressures and expectations pertaining to business' contribution to sustainable development. In this thesis issues reflecting stakeholder expectations or pressures are referred to as Sustainability Items

Part Two of this thesis is devoted measures and measurement of corporate sustainability performance.
Chapter 4 particularly focuses on measures of corporate sustainability performance. These measures can be roughly divided into two groups: multi-dimensional and uni-dimensional measures. Multi-dimensional measures usually comprise two or more sustainability related issues (or attributes), while uni-dimensional measures comprise only one issue (or attribute). In this chapter an overview (of the content) of an array of multi- and uni-dimensional measures is provided. A major drawback of both types of measures is the lack of sufficient theoretical underpinning. There is also no concrete evidence that these attributes reflect stakeholder expectations.
Measurement of corporate sustainability performance also requires clarification of the term *performance*. We observe that this term is differently interpreted by different scholars.

Chapter 5 is devoted to the construction of the Corporate Sustainability Analysis Framework (CSAF). Central to the CSAF is the identification and ranking of Sustainability Items. This framework is modeled on some of the corporate sustainability performance constructs, models and measures discussed in chapters 2 and 4.
Based on a selection of 24 (reporting) guidelines, such as the Global Reporting Initiative's *Sustainability Reporting Guidelines 2002*, the International Chamber of Commerce's *The Business Charter for Sustainable Development*, the Social Venture Network's , *Standards of corporate Social Responsibility*, the OECD's *Guidelines for Multinational Enterprises*, we have been able to identify well over 200 Sustainability Items. These Sustainability Items can be categorized as governance, social performance, environmental performance or economic performance related.

	Codes	Aspects	Weights
Governance	0.1	Overarching Principles	2,0%
	0.2	Overarching Processes	11,1%
	0.3	Stakeholders	2,7%
	0.4	Shareholders	1,7%
	0.5	The Board	3,0%
Social	1.1	Employees	26,9%
	1.2	Customers	7,4%
	1.3	Business partners	6,9%
	1.4	Community	12,3%
	1.5	Competitors	0,9%
	1.6	Providers of capital	0,1%
Environmental	2.1	Emissions	3,6%
	2.2	Life support	1,7%
	2.3	Products and services	2,9%
	2.4	Research and technology	0,8%
	2.5	Resources	4,2%
	2.6	Transport and equipment	0,9%
	2.7	Waste	2,3%
	2.8	Environmental conformance	4,9%
Economic	3.1	Economic market value	1,7%
	3.2	Economic performance drivers	0,2%
	3.3	Externalities	1,9%

Performance against Sustainability Items can be evaluated by means of four so-called performance domains: principles, practices, outcomes and stakeholder perceptions. *Principles* refer to (basic) values or beliefs adhered to by the company and apply to all constituting parts of the organization. Principles should provide guidance for practices, while *practices* are activities (e.g. procedures, programs, management systems) that shape corporate principles. *Outcomes* refer to positive and negative process results and can be expressed in terms of outputs and/or impacts. *Stakeholder perceptions* refer to how stakeholders perceive corporate performance in terms of principles, practices and outcomes in relation to the company as a whole or its constituting parts. Measures for gauging stakeholder perceptions are: satisfaction surveys, stakeholder feedback programs, suggestions made by stakeholders, etcetera.
Performance against Sustainability Items is aimed at warranting commitment towards sustainable development, safeguarding legitimacy and enhancing financial performance.
Not all Sustainability Items are likely to be equally relevant. In the accompanying table, Aspect weights are presented. Aspects comprise clusters of related Sustainability Items. The weights represent the relevance of these Sustainability Items as expressed by a broad range of stakeholder groups. As can be seen, with a weight of more than 54% the Social Dimension is the largest of the four Dimensions. Especially employee and community related issues are dominating. With a weight of little more than 21% the Environment Dimension is the second largest, closely followed by the Governance Dimension with an assigned weight of more than 20%. The weight distribution of the CSAF has been put to the test and is found to be robust.
Furthermore, we can say that (reporting) guidelines underlying the CSAF embody different perceptions of corporate sustainability performance, and cannot be used interchangeably for that matter.

Part Three primarily focuses on the investment community. Two issues in particular are central: whether or not the investment community is likely to value and understand corporate sustainability performance information and the reaction of the investment community to corporate sustainability performance information.

In chapter 6 the corporate sustainability performance assessment methodologies underlying the Dow Jones Sustainability World index (DJSI-World) and the Domini Social 400 index (DSI) are analyzed on the basis of *publicly available information*. The DJSI-World and DSI are launched and supported by the Swiss-based Sustainable Asset Management Group and the USA-based Kinder, Lydenberg and Domini Research & Analytics Inc. respectively.
A sustainability assessment methodology comprises a screening instrument and an assessment procedure. A screening instrument measures or evaluates corporate sustainability performance, while an assessment procedure describes how the results of the screening instrument are processed and synthesized. The CSAF is used to analyze the screening instruments underlying both indexes.
In order to value the message communicated by these assessment methodologies, first investors must be able to understand the message that is communicated. To our opinion, both instruments only limitedly cover issues that are appreciated by economic and ethical investors.
It is difficult to comprehensively depict the assessment procedures on the basis of publicly available information. As far as information is available it is complex, (possibly) outdated and (possibly) incomplete. The overall conclusion should therefore be that it is highly unlikely that the (results of the) of corporate sustainability performance assessment methodologies can be understood and (positively or negatively) valued by economic and ethical investors.

Chapter 7 is devoted to the reaction of investors to corporate sustainability performance information. In this respect corporate sustainability performance *information* specifically refers to (the results of) the sustainability assessment methodologies underlying the DJSI-World and the DSI. The term '*results of*' refers to additions to and deletions from both indexes. Additions are companies that are considered sustainability leaders as measured by the underlying methodologies, while deletions are companies that are no longer considered sustainability leaders.
To be able to answer the question as to whether or not the investment community responds to corporate sustainability performance information, an event-study has been conducted. The event being the announcement that companies will shortly be added to or deleted from the DJSI-World and the DSI.
We do find a market reaction if companies are announced to be deleted from and added to the DJSI-World and DSI respectively. These results are remarkable considering the conclusions of the previous chapter that investors are not likely to understand and value (the results of) these sustainability assessment methodologies. We hardly if at all find a market reaction in case of additions to the DJSI-World and deletions from the DSI.
Because of the asymmetrical results, a straightforward explanation cannot be provided. The asymmetry is likely to be due to irregularities in some variables, such as:

- *The indexes communicate different sustainability and financial performance signals*. As we have seen in the previous chapter, the corporate sustainability performance perceptions underlying the DJSI-World and DSI differ substantially. But financial performance of both indexes also differs substantially. Compared with a selection of peer indexes financial performance of the DJSI-World, is poor, while financial performance of the DSI can best be classified as on par.
- *Corporate sustainability performance and financial performance signals of these indexes are differently interpreted by investors*. As we have seen in the previous chapter, the DSI is an ethical index. Companies added to the DSI are not involved in ethical concerns such as, production of weaponry, nuclear power, alcohol etcetera. The DJSI-World is a sustainability index. Unlike ethical indexes, sustainability indexes do not a priory put restrictions on investment possibilities. Besides, SAM claims that a positive link exists between (its interpretation and operationalization of) corporate sustainability performance leadership and financial performance. It may be that these indexes are differently perceived by different audiences. Moreover, the reputations of SAM and KLD in the market may also attract different audiences.
- *Companies that have been included in the DJSI-World were perceived to be socially and environmentally responsible long before they were announced to be added to the index*, in which case announcements do not communicate new information, leaving share prices unaffected.
- It may also be that *audiences responding to DJSI-World additions are relatively small* to an extent that share prices do not increase if addition announcements are disseminated to the market. Investors may also respond to this sustainability signal at a later point in time. Because these actions take place within a longer time-frame, we do not find (cumulative) abnormal returns.
- However, if companies are announced to be deleted from the DJSI-World, investors react by selling their shares, causing share prices to fall substantially, resulting in negative (cumulative) abnormal returns. Because *investors* know that index returns are relatively low they *have no financial interest in holding these shares*.
- In case of the DSI additions, investors may not aware of their sustainability performance leadership until the addition announcements are made public. Since, financial performance of the DSI is not particularly strong, it is likely that shares of additions to the index are bought mainly for sustainability performance reasons.
- Investors do not respond equally strong to DSI addition and deletion announcements. They strongly respond if companies are added to the DSI, but hardly if at all respond to the signal that companies are deleted from the index. In case of additions, investors obviously respond for sustainability reasons. If companies are deleted, investors do not (immediately) sell shares of these companies. Investors may hold these shares because it is not necessary to sell them for financial reasons, since financial performance of the DSI is fairly in line with that of a set of peer indexes.

However, if we combine the results of the DJSI-world and DSI, we can say that investors positively respond to additions to sustainability/ethical indexes and negative respond if companies are deleted from these indexes. In this case we can say that investors obviously purchase stock of additions and sell stock of deletions on the basis of sustainability/ethical considerations.