

Corporate investment in social responsibility versus dividends?

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Abstract

Purpose – *The paper aims to examine whether corporate investment in social responsibility takes away from expected dividends.*

Design/methodology/approach – *The article builds two hypotheses that are tested empirically through the analysis of 17,670 US firm-year observations covering the period 1991-2007. The tests are conducted in both univariate and multivariate settings.*

Findings – *The evidence supports the hypothesis that mature firms tend to invest more in corporate social responsibility (CSR). Specifically, firms investing highly in CSR tend to be larger, more profitable, and with greater earned (rather than contributed) equity. The evidence also supports the hypothesis that CSR investment does not subtract from dividends. Instead, CSR effort and dividend tend to increase together. Thus, CSR investment tends to be effected by companies who can afford it, and it does not lower value by lowering investors' expected payout.*

Practical implications – *These results imply that spending resources on CSR does not lower the cash flows paid out to investors. When combined with the finding that CSR lowers the cost of equity, they also mean that CSR increases the value of a company's stock.*

Originality/value – *This is the first study that explicitly links CSR to the dividend flow.*

Keywords *Corporate social responsibility, Investment, Dividends, Payout, Stock prices*

Paper type *Research paper*

Introduction

So much has been written about the possible relation between corporate performance on social responsibility (CSR performance) and corporate financial performance (CFP) that reviewing the literature reviews has become possible. For example, Orlitzky *et al.* (2003) effected a meta-analysis of 52 studies. They found a positive link between CSR performance and CFP that emanates from increased reputation and goodwill with external stakeholders. Margolis and Walsh (2003) analyzed 127 studies. They too found a generally positive impact of CSR performance on CFP. Van Beurden and Gossling (2008) reviewed 24 studies. Two thirds of those studies reported a positive relation between CSR performance and CFP. More recent, non-review papers have focused on the fact that a negative relation between CSR performance and financial returns may be the expression of a lowered risk premium caused by a decrease in risk. For example, El Ghoul *et al.* (2010) examine a sample of 12,915 US firm-year observations from 1992 to 2007 and use various approaches to estimate the *ex ante* cost of equity capital. They conclude that firms with higher CSR performance tend to have a lower cost of equity.

Given the high level of attention paid to the effect of CSR performance on CFP, it is surprising that no study has yet examined the impact of corporate investment in social responsibility (CSR investment) on cash dividends. Specifically, does such investment subtract from investors' dividends? This question is important because the value of a company's stock is a positive function of its stream of future cash dividend payments and a negative function of its

cost of equity. CSR's cost-lowering effect reported by El Ghouli *et al.* (2010) will be fully reflected in stock value only if CSR investment does not cut into dividends.

The rest of the paper is organized as follows. The second section develops the paper's hypotheses. The third section discusses the data and methodology. The fourth section reports the results, and the last section concludes the paper.

Hypotheses

Freeman's (1984) stakeholder theory holds that a corporation should satisfy all of its legitimate stakeholders, not only its stock shareholders; stakeholders can affect and/or are affected by the achievement of the corporation's objectives. Investment in CSR is a form of direct or indirect payout to various stakeholders. Charitable giving, volunteer programs, support for local housing are some of the ways a corporation pays a local community. Any additional expenses caused by strong union relations or a no-layoff policy or a cash profit-sharing plan are payouts to employees. The costs of pollution prevention, recycling efforts, alternative fuels usage, are indirect payouts to society at large. These are only a few examples.

The life-cycle view of corporate payout policy, focused on dividends, has received strong support in the finance literature. For example, DeAngelo and DeAngelo (2006) show that, even in a Miller-Modigliani world, dividend policy is actually relevant, and the optimal policy is to pay the full present value of free cash flow. Thus, they formulate the following:

In their early years, firms' investment opportunities generally outstrip their ability to generate internal capital, hence firms raise outside equity and pay no dividends. In later years, firms' ability to generate internal equity outstrips their profitable investment opportunities and agency problems come to the fore, so that firms pay dividends and repurchase stock to mitigate opportunities for free cash flow wastage.

There is plenty of evidence supporting this life-cycle view. Fama and French (2001) provide evidence indicating that firms that pay dividends tend to be large and profitable, with fewer investment opportunities. On the other hand, firms that have never paid dividends tend to be smaller, less profitable, with more investment opportunities. DeAngelo *et al.* (2006) use the retained earnings/total equity and retained earnings/total asset ratios as proxies for firm maturity. They also find that more mature firms are more likely to pay dividends, and that maturity has a greater impact on the likelihood of dividend payment than profitability and growth. Grullon *et al.* (2002) focus on dividend changes rather than the pay/no pay decision. They show that firms that increase dividends tend to experience a decline in their systematic risk and their change in return on assets. Conversely, when firms decrease dividends, their systematic risk and the change in their return on assets tend to increase.

Even though the above research is explicitly focused on dividend payments, the underlying idea is that mature firms tend to afford greater payouts and proceed forward to avoid free cash flow wastage. Therefore, my first hypothesis is that firms that invest in CSR are mature firms. Jawahar and McLaughlin (2001) arrive at a similar conclusion by using a different approach. They base their argument on both resource dependence theory and prospect theory. In particular, their Proposition 3 reads:

During the mature stage, resource allocation decisions will be framed in the context of gains, and a risk-averse strategy of proaction will be used to deal with all stakeholders, except for creditors, who will be accommodated.

DeAngelo *et al.* (2006), and others, use the retained-earnings-to-total-asset and the retained-earnings-to-total-equity ratios as proxies for firm maturity. Thus, my first hypothesis is:

H1. Investment in CSR is positively associated with the retained-earnings-to-total-asset ratio, the retained-earnings-to-total-equity ratio, company size, and company profitability.

My second hypothesis directly addresses the link between CSR investment and dividends. By the first hypothesis, mature firms effect more CSR investment because they possess the

wherewithal to do so. On the other hand, the value of a company's stock is positively related to its expected flow of future dividends. In his seminal article, Lintner (1956) reported that managers were averse to changing dividend rates, based on their belief that stockholders preferred stability. Thus, only part of earnings changes were reflected in dividends. Consistent dividend patterns were believed to minimize adverse stockholder reaction. Fifty years later, Brav *et al.* (2005) state that maintaining dividend levels is still a top priority for managers. Specifically, "managers express a strong desire to avoid dividend cuts, except in extraordinary circumstances". And even "increases in dividends are considered only after investment and liquidity needs are met". Therefore, it is not likely that companies will cut dividends to increase their CSR investment. This yields:

H2. Investment in CSR is not negatively associated with the deviations of current dividends from past dividend policies.

Data and methodology

The data cover the 1991-2007 period. The source of annual CSR ratings data is KLD Research and Analytics. Table I summarizes the ratings categories. Similar to Baron *et al.* (2009), I use a proxy for CSR investment by summing up the values of the strength indicators for the firm and dividing the result by the total number of strength indicators for the year. CSR performance (i.e. CSP) may be better measured by a combination of the strengths and weaknesses. However, this paper's main hypothesis focuses on resources spent on CSR, not on results (which should include weaknesses).

For example, Table I shows generous giving as a community strength and investment controversies as a community weakness. I proxy resources spent on CSR investment by

Table I KLD corporate social responsibility ratings indicators (1991-2007)

Category	Strength indicators	Concern indicators
Community	Generous giving, innovative giving, support for housing, support for education, (added in 1994), non-US charitable giving, volunteer programs (added 2005), other strength	Investment controversies, negative economic impact, tax disputes (added 2005), other concern
Corporate governance	Limited compensation, ownership strength, transparency strength (added 2005), political accountability (added 2005), other strength	High compensation, ownership concern, accounting concern (added 2005), transparency concern (added 2005), political accountability concern (added 2005), other concern
Diversity	CEO, promotion, board of directors, family benefits, women/minority contracting, employment of the disabled, progressive gay/lesbian policies (added in 1995), other strength	Controversies, non-representation, other concern
Employee relations	Union relations strength, no layoff policy (through 1994), cash profit sharing, involvement, retirement benefits strength, health and safety strength (added in 2003), other strength	Union relations concern, health and safety concern, workforce reductions, retirement benefits concern (added in 1992), other concern
Environment	Beneficial products and services, pollution prevention, recycling, alternative fuels, property, plant, and equipment (through 1995), management systems (added 2006), other strength	Hazardous waste, regulatory problems, ozone depleting chemicals, substantial emissions, agricultural chemicals, climate change (added in 1999), other concern
Human rights	Positive operations in South Africa (1994-1995), indigenous peoples relations (added in 2000), labor rights strength (added in 2002), other strength	South Africa concern (through 1994), Northern Ireland concern (through 1994), Burma (added in 1995), Mexico (1995-2002), labor rights concern (added in 1998), indigenous peoples relations (added in 2000), other concern
Product	Quality, benefits to economically disadvantaged, other strength	Product safety, marketing/contracting concern, antitrust, other concern

focusing on generous giving and ignoring investment controversies. On the other hand, while CSR performance would increase with generous giving, it would decrease with investment controversies. Similar to Baron *et al.* (2009), I view KLD weakness/concern measures such as investment controversies as a proxy for social pressure, rather than an indication of CSR resource allocation. It is also worth noting that the KLD strengths cited in Table I are (implicitly) positively related to incremental corporate expenditure on CSR.

The ratios of retained earnings to total assets and retained earnings to total common equity (where total common equity is positive), as well as dividends and earnings before extraordinary items, are from Compustat.

Similar to DeAngelo *et al.* (2006), who study the relation between dividends and the earned/contributed capital mix, I use the following control variables to study the link between CSR investment (another form of payout by *H1*) and the same earned/contributed capital mix:

- total equity to total assets;
- return on assets (ROA);
- one-year-lagged ROA;
- sales growth rate;
- NYSE equity value percentile; and
- cash to total assets.

All data are from Compustat.

To test whether CSR investment cuts into dividends (*H2*), I use the following control variables:

- logarithm of the market value of equity;
- ROA;
- standard deviation of the ROA over the three years surrounding the year of observation;
- non-operating income before depreciation divided by total assets; and
- long-term debt plus short-term debt divided by total assets.

Grullon and Michaely (2002) use the same control variables while testing whether share repurchases cut into dividends. The idea is to avoid spurious correlation caused by fixed effects, such as firm characteristics, that may affect both dividends and CSR investment. Again, the data source is Compustat.

To estimate each regression model in this study, I use the Fama and French (2000) procedure to take residual cross-correlation into account. First, I estimate the regression equation for each year in the sample. Second, I compute the time-series average and standard error for each regression coefficient. I make inferences based on those two statistics.

The sample includes 17,670 firm-year observations. Table II reports some sample statistics. High-CSR investing firms (with scores above the median value) are larger (both in terms of sales and capitalization), are more profitable (both in terms of ROE and ROA), use more debt (less equity), have more retained earnings, and pay out more dividends. The differences are all statistically significant at the 1 percent level. These results tend to support the idea of a positive association between CSR investment and firm maturity.

Results

Investment in corporate social responsibility and retained earnings

DeAngelo *et al.* (2006) argue on page 228 that “Firms with low RE/TE (RE/TA) tend to be in the capital infusion stage, whereas firms with high RE/TE (RE/TA) tend to be more mature

Table II Sample statistics

	Median	High CSR investment	Low CSR investment	High = low
CSR investment	0.0256	0.0555	0.0000	No
Retained earnings/common equity	0.4779	0.5670	0.3779	No
Retained earnings/total assets	0.1455	0.1702	0.1216	No
Total equity/total assets	0.4468	0.4206	0.4718	No
Return on equity	0.1132	0.1230	0.1026	No
Return on assets	0.1155	0.1178	0.1132	No
Dividends (\$, millions)	245.00	375.00	172.36	No
Sales (\$, millions)	982.91	1,711.5	665.11	No
Market capitalization (\$, millions)	1,467.1	2,423.9	1,012.1	No

Notes: The sample covers the 1991-2007 period and contains 17,670 firm-year observations. Investment in corporate social responsibility (CSR investment) is the sum of the values of the strength indicators for the firm, divided by the number of strength indicators. The high (low) CSR investing group is composed of observations with an investment score greater (lower) than the median score. Return on equity is earnings before extraordinary items divided by the equity book value. Return on assets is operating income before depreciation divided by total assets. The hypothesis of equality of medians across high and low CSR investing observations is rejected at the 1 per cent level for all variables. The data sources are KLD Research and Analytics, and Compustat

with ample cumulative profits that make them largely self-financing . . .". RE/TE (RE/TA) is the retained-earnings-to-total-equity (retained-earnings-to-total-assets) ratio.

Table III shows a monotonically positive relation between CSR investment and the earned/contributed equity mix. Panel A reports the median CSR investment scores for the first third of RE/TE values (with a median of -45.6 percent), the second third (with a median of 35.72 percent), and the last third (with a median of 84.14 percent). The results are, respectively, 0 percent, 2.56 percent, and 2.78 percent. Equality between these scores is rejected at the 1 percent level. Panel B reports the median CSR investment scores for RE/TA groups. The results for CSR investment (RE/TA) are, respectively, 2.44 percent (-20.11 percent), 2.56 percent (9.07 percent), and 2.78 percent (39.68 percent). Again, equality between these scores is rejected at the 1 percent level.

Table III also shows a monotonic and positive relation between CSR investment and profitability (measured by ROA). The results for CSR investment (ROA) are 3.67 percent (1.7 percent), 3.88 percent (10.7 percent), and 4.63 percent (20.3 percent). Similarly, the results for CSR investment against size (as measured by the percentile in which the firm value falls in the full NYSE equity market distribution) are 2.115 percent (16 percent), 2.5 percent (49 percent), and 6.3 percent (82 percent).

Table III Investment in corporate social responsibility as a function of earned equity, size, and profitability

Panel A: Ranking by retained earnings/common equity (median)	-0.4560	0.3572	0.8414	Equality
Investment in corporate social responsibility (median)	0.0000	0.0256	0.0278	No
Number of observations	4,609	5,799	7,262	
Panel B: Ranking by retained earnings/total assets (median)	-0.2011	0.0907	0.3968	Equality
Investment in corporate social responsibility (median)	0.0244	0.0256	0.0278	No
Number of observations	4,620	5,841	7,209	
Panel C: Ranking by return on assets (median)	0.017	0.107	0.203	Equality
Investment in corporate social responsibility (median)	0.0367	0.0388	0.0463	No
Number of observations	4,715	6,629	6,326	
Panel D: Ranking by NYSE equity percentile (median)	0.16	0.49	0.82	Equality
Investment in corporate social responsibility (median)	0.0211	0.0250	0.063	No
Number of observations	5,328	5,763	6,579	

Notes: The sample covers the 1991-2007 period and contains 17,670 firm-year observations. Investment in corporate social responsibility (CSR investment) is the sum of the values of the strength indicators for the firm, divided by the number of strength indicators. Return on assets (ROA) is operating income before depreciation divided by total assets. Size is measured by the NYSE equity value percentile. The hypothesis of equality of CSR investment medians across subgroups is rejected at the 1 percent level. The data sources are KLD Research and Analytics and Compustat

Table IV reports the results of the related multivariate analysis. Similar to the analysis of the relation between dividends and the earned/contributed capital mix by DeAngelo *et al.* (2006), I use total equity to total assets, return on assets (ROA), one-year-lagged ROA, sales growth rate, NYSE equity value percentile, and cash to total assets as control variables. Since the dependent variable, CSR investment, is bounded, I use an inverse logit transformation for its regressions against the above explanatory variables; however, I report the regressions of the untransformed variable because the results are qualitatively the same and the regression coefficients have a straightforward interpretation. Regression 1 (Regression 2) uses RE/TE (RE/TA) and the control variables as regressors. The results are consistent across both regressions. Both the coefficients for RE/TE and RE/TA are positive and statistically significant. Profitability, as measured by the lagged ROA, is positive and significant in both regressions. Also, size, as proxied by NYSE equity value percentile, is positive and significant. Hence, the evidence from Tables II and Table III, that larger, more profitable firms with greater retained earnings tend to invest more in CSR, is confirmed in the multivariate setting. This evidence suggests a positive link between firm maturity and CSR investment.

Investment in corporate social responsibility and dividends

Fama and French (2001), Grullon *et al.* (2002), and DeAngelo *et al.* (2006) provide strong evidence indicating that the decision to pay or increase dividends is linked to the maturity of the firm. If mature firms invest more in CSR because they possess the means to do so and if

Table IV Investment in corporate social responsibility as a function of earned equity, size, and profitability: a multivariate analysis

	(1)	(2)
RE/TE	0.0035*** (8.68)	
RE/TA		0.0064*** (8.16)
TE/TA	−0.0302*** (−51.21)	−0.0328*** (−60.94)
ROA	−0.0048 (−0.84)	−0.0078 (−1.39)
One-year lagged ROA	0.0209*** (3.50)	0.0247*** (4.46)
Sales growth rate	0.0001 (0.06)	0.0001 (0.04)
Size	0.0560*** (23.34)	0.0582*** (25.77)
Cash/TA	0.0429*** (13.18)	0.0415*** (12.81)
Intercept	0.0266*** (11.48)	0.0264*** (11.32)
Average adjusted R^2 (percent)	15.33	14.91

Notes: The sample covers the 1991-2007 period and contains 17,670 firm-year observations. Investment in corporate social responsibility (CSR investment) is the sum of the values of the strength indicators for the firm, divided by the number of strength indicators. RE/TE (RE/TA) is the retained-earnings-to-total-equity (retained-earnings-to-total-assets) ratio. TE/TA is total equity to total assets. Return on assets (ROA) is operating income before depreciation divided by total assets. Sales growth rate is the percentage change in sales. Size is measured by the NYSE equity value percentile. The data sources are KLD Research and Analytics and Compustat. The *t*-statistics are shown in parentheses. The regression coefficients and *t*-statistics are estimated as in Fama and French (2000). ***Denotes significance at the 1 percent level

managers are strongly averse to dividend cuts, then CSR investments should not cut into dividends.

Grullon and Michaely (2002) use the Lintner (1956) model to estimate expected dividends. They argue that if the deviations from these expected amounts (i.e. the dividend forecast errors) are negatively (positively) correlated with share repurchases, then the dividend/share repurchase decisions are substitutes (complements). I use their equation (1) to estimate the dividend forecast errors:

$$\text{ERROR}_{t,i} = [\Delta \text{DIV}_{t,i} - (\beta_{1,i} + \beta_{2,i} \text{EARN}_{t,i} + \beta_{3,i} \text{DIV}_{t-1,i})] / \text{MV}_{t-1,i}, \quad (1)$$

where t refers to the year, i refers to the firm, DIV is dividend level, EARN is earnings, MV is the market value of equity, and Δ is the change operator. The values of β are estimated over the pre-forecast period of 1991-2001.

Table V shows a monotonic and positive relation between CSR investment and dividend forecast error. The greater the CSR investment, the higher the actual dividend when compared with the expected dividend. For example, the low-CSR investing group, with a median score of 2.50 percent, has a median dividend forecast error of 0.08 percent. On the other hand, the high-CSR investing group, with a score of 44.45 percent, has a dividend error of 0.31 percent.

Table VI reports the Fama-French regression of dividend forecast errors against CSR investment, when the following Grullon and Michaely control variables are used:

- logarithm of the market value of equity;
- ROA;
- standard deviation of the ROA over the three years surrounding the year of observation;
- non-operating income before depreciation divided by total assets; and
- long-term debt plus short-term debt divided by total assets.

Even after firm characteristics are controlled, the relation between dividend forecast error and CSR investment remains positive and statistically significant. Therefore, the evidence suggests that firms that invest more in CSR tend to pay dividends that are greater than expected. These results tend to support the idea that CSR investment does not take away from dividends.

Conclusion

This paper examines the link between investment in corporate social responsibility (CSR) and dividends. The evidence is consistent with the hypothesis that mature firms tend to invest more in CSR. In particular, high-CSR investing firms tend to be larger, more profitable, and with greater earned (rather than contributed) equity. These results hold in both

Table V Relation between investment in corporate social responsibility and dividend forecast errors

	<i>Entire sample</i>	<i>Groups ranked by CSR investment</i>				
		<i>1 (Low)</i>	<i>2</i>	<i>3</i>	<i>4 (High)</i>	<i>Equality</i>
Dividend forecast error (median)	0.0010	0.0008	0.0024	0.0025	0.0031	No
Investment in corporate social responsibility (median)	0.0256	0.0250	0.1714	0.3030	0.4445	No
Number of observations	17,670	16,416	1,104	140	10	

Notes: The sample covers the 1991-2007 period and contains 17,670 firm-year observations. The dividend forecast errors are estimated as $\text{ERROR}_{t,i} = [\Delta \text{DIV}_{t,i} - (\beta_{1,i} + \beta_{2,i} \text{EARN}_{t,i} + \beta_{3,i} \text{DIV}_{t-1,i})] / \text{MV}_{t-1,i}$, where t refers to the year, i refers to the firm, DIV is dividend level, EARN is earnings, MV is the market value of equity, and Δ is the change operator. The values of β are estimated over the pre-forecast period of 1991-2001. Investment in corporate social responsibility (CSR investment) is the sum of the values of the strength indicators for the firm, divided by the number of strength indicators. The hypothesis of equality of medians across subgroups is rejected at the 1 percent level. The data sources are KLD Research and Analytics and Compustat

Table VI Regression of dividend forecast error against investment in corporate social responsibility and other factors	
Investment in corporate social responsibility	4.6818*** (3.43)
Logarithm of the market value of equity	−0.0669*** (−3.37)
Return on assets (ROA)	−0.7464*** (−7.39)
Standard deviation of the ROA	0.7129*** (4.55)
Non-operating income before depreciation divided by total assets	−0.5208 (−0.83)
Long-term debt plus short-term debt divided by total assets	0.4560*** (7.24)
Intercept	0.0776*** (4.20)
Average adjusted R^2 (percent)	11.89
Notes: The sample covers the 1991-2007 period and contains 17,670 firm-year observations. Investment in corporate social responsibility (CSR investment) is the sum of the values of the strength indicators for the firm, divided by the number of strength indicators. Return on assets is operating income before depreciation divided by total assets. The standard deviation of the ROA is measured over the three years surrounding the year of observation. The data sources are KLD Research and Analytics and Compustat. The <i>t</i> -statistics are shown in parentheses. The regression coefficients and <i>t</i> -statistics are estimated as in Fama and French (2000). ***Denotes significance at the 1 percent level	

univariate and multivariate settings. The evidence also suggests that CSR investments do not take away from dividends, even when firm characteristics are used as control variables. This finding is justified in the paper by corporate managers' reluctance to change dividend rates (Lintner, 1956; Brav *et al.*, 2005). Interestingly, managers in Japan and Greece are also averse to changing dividend patterns (respectively in Mizuno, 2007; Papadopoulos and Charalambidis, 2007). Thus, a similar analysis in those and other countries might lead to a similar finding.

These results add to the understanding of CSR. In particular, they may explain why some firms are engaged in CSR investment while others are not. Financial resources accumulated through the maturation process seem to be a factor. Also, if CSR performance lowers the cost of equity (El Ghouli *et al.*, 2010), the result that CSR investment does not cut into dividends implies that CSR may increase the value of a firm's stock.

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