

Finding the Link Between Stakeholder Relations and Quality of Management

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For years scholars have been engaged in a seemingly endless and largely frustrating studies of the relationship between the social and financial performance of the corporation. The bulk of empirical research on corporate social performance (CSP) has addressed a hypothesized relationship between CSP and financial performance. The results of these studies attempting to link "socially responsible" behaviors to either market or accounting based measures of firm performance have been ambiguous at best, partly because of methodological problems related to the measurement of CSP and partly because the relationship itself is unclear. Financial data are, of course, readily available, reasonably consistent, and relatively easily measurable. CSP, on the other hand, has been ill-defined and measured in a wide range of ways. Many past studies have used different measures as proxies for CSP, which inadequately reflect its breadth as a concept. Finally, scholars have focused to date primarily on the question "Is financial performance related to social performance?" We argue for a reformulation of the question that emphasizes the link between social performance and the way an organization is managed, i.e., that explicitly focuses on stakeholder relations.

CSP and Stakeholders

Stakeholder theory as it is understood today was popularized by Ed Freeman in a 1984 book called ***Strategic Management: A Stakeholder Approach***. Freeman defined a stakeholder as "any group or individual who can affect or is affected by the achievement of the organization's objectives" (p. 46). Classifications of stakeholders can further be understood as primary or secondary, with primary stakeholders the market-driven ones, including customers, suppliers, employees, and investors, and possibly the environment because of the need for raw materials. Secondary stakeholders are more ancillary, for example, communities and governments.

Rather than attempting to understand whether CSP is related to financial performance, in our paper we shift the research question so that we ask "Is the quality of management in companies related to their treatment of primary stakeholders." That is, we are interested in considering the relationship between perceived quality of management and stakeholder relations. Quality of management can conceivably be understood, at least in part, as the firm's overall reputation for being soundly run. Importantly, this reframing of the basic research question places financial performance, considered now as a **measure** of the way owners or shareholders are treated, **with** other stakeholders as part of the constellation of constituents to which successful companies need to pay attention.

The hypothesis is supported by evidence from strategic management. Real expectations for the firm seem to be broader than traditional measures of financial performance alone. Evidence from the strategic management literature supports this assertion, finding that superior performance is associated with broad product lines, geographic diversity, planning and sound financial controls, superior quality and customer service, and progressive human resource management practices, and adaptiveness. Further, the Malcolm Baldrige National Quality Award recognizes CSP

and other aspects of good quality management as an essential component of excellent performance in their 1996 award criteria. Clearly, new connections are now being made between overall management performance and topics once considered only peripheral to the strategic success of the firm.

Redefining Social Performance

What emerges from this reframing is a redefinition of corporate social performance **as** the treatment of stakeholders, with owners, one of the important stakeholder groups sharing the stage with other primary stakeholders, such as customers, employees, communities, and the environment. This redefinition moves understanding of CSP away from strictly discretionary activities such as philanthropy or volunteerism and toward an understanding that CSP is integrally related to the daily operating practices of a firm, particularly with respect to those most affected by the activities of the firm, the primary stakeholders. CSP, then, is **not** simply a set of discretionary activities undertaken when there are sufficient slack resources. Rather, firms operate on a routine basis with and through their primary (and perhaps some of their secondary) stakeholders to effect their strategies. We argue that it is the quality of these relationships that fundamentally defines the quality of a company's CSP.

Social performance is the quality of a corporation's stakeholder relations!

Additionally, and importantly, we suggest that in assessing stakeholder relations, we are also assessing the overall quality of management in a given firm. What this study tests, then, is the relationship between quality of management and stakeholder relations in an effort to determine whether these elements of performance are, in fact, synonymous.

The Study

In our study we wanted to compare the relationship of management quality to treatment of specific stakeholders. To address the issue of management quality, we used *Fortune's* annual survey of executives, directors, and analysts, which generates reputational ratings for the *Fortune* 500 largest firms and is published as "America's Most Admired Companies." One indicator among the eight *Fortune* variables is called "quality of management." We used this variable to measure quality of management. In addition, in one part of the study, we used the combined overall reputational rating (partly because the ratings themselves are highly correlated with each other) to measure management quality.

Additionally, we needed to measure the quality of significant primary stakeholder relationships, including relationships with shareholders (owners), employees, and customers. Treatment of the ecological environment is also assessed because of the increasingly recognized strategic importance of the environment as a source of raw materials and repository of by-products. Finally, as a surrogate for secondary stakeholder relationships, community relations is used to indicate business' involvement with its broader society.

To measure stakeholder relationships other than ownership (for which we used accounting and market-based financial measures), we used data from the social research firm Kinder, Lydenberg, Domini. KLD provides comprehensive annual

assessments of the Standard & Poor's (S&P) 500 firms on ten characteristics of CSP. This rating scheme provides a consistent, externally-derived measure of these elements of CSP across the multiple companies. In our study, we used five-point ratings (± 2) for four stakeholder categories: employee relations, product (a surrogate for treatment of customers), community, and environment for four years, 1990-1993.

Treatment of owners as measured by financial performance becomes a stakeholder category measured (in different models) by: ten year compounded total return to shareholders (a market measure), ROA, (return on assets), and ROE (return on equity). Controls were used for industry (37 industries were included in the study, with a total of 839 usable observations), risk (debt/assets), and size (number of employees). In the full article, all relevant descriptive statistics are presented. Regression analysis was employed to test the hypothesis that quality of management (the dependent variable) is related to stakeholder relations (independent variables).

The Results

To test the robustness of results, we ran four regression models, with strikingly similar across all runs. Table 1 gives regression results for the four models. The first three models all use the **Fortune** management score as the measure of management quality, while the fourth uses **Fortune** overall score. The first three models differ only in the choice of measure for financial performance, with the first using total ten year return to shareholders, the second using ROE, and the last using ROA.

In all four models, the relationship between quality of management and treatment of owners (measured by financial performance), employee relations, and product (the surrogate for customer relations), is strongly and consistently positive. Community relations is significantly and positively related to quality of management in two of the models, suggesting some support for this relationship. Treatment of the ecological environment, however, is not significantly related to quality of management in any of the models.

As an interesting aside, the debt-to-asset ratio has a significant negative relationship with management quality, suggesting that survey respondents gave higher evaluations to companies with lower relative debt loads than to those with higher debt. Even when a company is compared to its industry peers, its performance will receive more favorable ratings, other things equal, if management holds down debt. Employee count also showed a positive and significant relationship, which indicates that management quality of larger companies is rated more favorably, than that at smaller companies with otherwise similar performance characteristics.

Overall, the results indicate that overall company reputation for performance is rated more favorably when management practices result in better treatment of owners, strong employee relations, and good product/customer relations. On the other hand, this results also indicates that the, at least to date, external evaluators pay little attention to environmental practices and are only marginally interested in the ways in which companies treat their communities.

So What?

What can we learn from these results? The most striking finding is that while treatment of shareholders/owners certainly plays an important role in external assessments of the quality of management in firms, other factors are also significant. Attention to a range of stakeholders critical to the effectiveness of any organization is also important. These other stakeholders include employees, customers, and, to some extent, communities. Environment was not an important factor in developing reputation for quality management. We are also intrigued by the finding that, other things equal, higher debt levels are associated with lower reputational ratings, which is contrary to much of the conventional wisdom holding that debt fosters better agency from managers.

There are a number of implications of this study. First, we believe that it is time that new linkages between overall management of firms and the ways that they treat stakeholders need to be explored. For years, scholars have attempted to find a relationship between social and financial performance. The results of this study strongly indicate that framing the question in different ways, such as exploring the link between quality of management and stakeholder relations, may prove a more fruitful and less frustrating endeavor. But this reframing also suggests that the definition of CSP that makes sense may differ from the traditional and common-wisdom understanding of CSP discretionary or philanthropic activities. The new definition should support the understanding that "doing good" by stakeholders, i.e., treating them well in an on-going, operational way, may be the best way to build not only successful financial performance but overall organizational performance as well.

The redefinition of CSP also integrates two literatures in the business and society arena by proposing the possibility that treatment of stakeholders is, in fact, the way in which social performance as a nondiscretionary responsibility of the firm can best be measured. Perhaps this linkage can help both managers and scholars more completely link ethical considerations into management as a whole without damaging the important relationships (and agency) between management and owners. In other words, we suggest that good treatment of owners through good financial performance is entirely consistent with good treatment of other important stakeholders. Contrary to popular belief the relationship seems to be one of both/and (doing well and doing good, meaning implementing good operating stakeholder practices) rather than the either/or of having to make trade-offs among stakeholders. This study implies that such trade-offs in performance, in fact, need not be made and that at least to some extent excellent performance with respect to a given set of stakeholders accords quite well with good treatment of other stakeholders.

For practicing managers, the implications are even clearer. Managers—and investors—may need to consider not only financial performance of firms if they hope to find well managed and successful enterprises. Companies that can balance their sound treatment of multiple constituencies are those that are rated as having the highest quality of management. Managers may thus need to consider an array of stakeholders—and not just owners—in their decision making. It appears that a narrow adherence to maximization of shareholder wealth will not be adequate to develop a reputation for strong management performance. The data strongly indicate that key components of quality of management may be interlinked and that they relate not only to financial performance, but also to the ways in which key constituents, primarily employees and customers, and also to some extent communities, are treated.

Good management, then, may require not only treating shareholders well by performing well financially, but also treating employees well through humane and decent employee relations policies as well as managing diversity in favorable ways (the two components of the measure used). Good management also apparently is related to treating customers well by developing safe, effective, and useful products or services. Further, treatment of communities, while the least strongly associated with overall perceptions of quality of management, is apparently also a factor to which some degree of attention needs to be paid in developing a company's reputation for high quality of management.

The lack of significance for ecological environmental concerns may be related to a general lack of awareness of the relevance of environmental issues to the corporate world. To some extent, environmental awareness among corporations is a relatively recent phenomenon. Environmental consciousness thus may not yet be a key component of corporate consciousness or of the consciousness of those who assess company performance from the outside, hence its lack of significance as a stakeholder.

Obviously, much more work remains to be done with the present research question to address possible linkages between overall company performance, in the present research measured as quality of management, and corporate social performance measured by treatment of a range of stakeholders. Scholars may find measures of company performance better than the **Fortune** ratings to assess company performance or quality of management. Further investigation into the specific practices in companies that are rating highly on both quality of management and CSP/stakeholder relations should shed important light on management practices that work over the long term.

Conclusions

As we have argued, the findings of this study support the idea that the quality of management of one's stakeholders reflects the quality of a company's social performance. For managers, the findings presented above may indicate that a broader conception of their responsibilities may be necessary if they are to enhance shareholder wealth. It would appear from these results that enhancing owner interests may be inevitably bound to the ways in which companies treat their employees, and their customers. To the extent that this finding continues to hold true over time, it may be an occasion for a major shift in the ways that managers think about key decisions and priorities.

Table 1: Regression results

<u>Model No.</u>	1	2	3	4
Dependent Variable	Management Score	<u>Fortune</u> Management Score	<u>Fortune</u> Management Score	<u>Fortune</u> Overall Index
Independent Variables				

Total Return	6.30***			4.92***
ROE		1.59***		
ROA			5.45***	
Employee Relations	.215***	.220***	.226***	.236***
Community Relations	.084*	.069	.072	.136***
Product	.240***	.285***	.295***	.191***
Ecological Environment	-0.022	.024	.014	.011
Employee count	.154E-5***	.210E-5***	.198E-5***	.169E-5***
Debt-to-asset ratio	-1.68***	-1.73***	-0.996***	-1.68***
n	812	812	812	812
R2 for full model	.499	.360	.369>	.549
R2 for dummy variables alone	.121	.130	.113	.114
F	32.7	20.5	20.1	40.3

* p<.05 | ** p<.01 | *** p<.001

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