

# **When CSR/ESG Pays — and When It Doesn't**

*Risk Mitigation, Materiality, and the Governance Conditions for Financial Performance*

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### **Abstract**

Debate over corporate social responsibility (CSR) and environmental, social, and governance (ESG) investing has often been framed in binary terms: either as a source of systematic outperformance or as a distraction from fiduciary duty. This paper evaluates empirical literature and reframes the discussion through a governance lens. The evidence does not support universal claims of excess returns. Instead, it suggests that financial effects are conditional and arise through identifiable mechanisms, most consistently through downside risk mitigation. Financial relevance depends on economic materiality, governance integration, and horizon alignment. By synthesizing meta-analytic research, ratings disagreement studies, event-based evidence, and materiality-focused findings, the paper proposes a structured framework for boards and investment committees. Rather than advocating or dismissing ESG, it positions stakeholder governance as a conditional component of disciplined capital allocation.

**Keywords:** corporate social responsibility (CSR); environmental, social, and governance (ESG) investing; financial performance; risk mitigation; economic materiality; corporate governance; fiduciary duty; institutional capital; capital allocation; downside risk.

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## **1. Introduction — Reframing the Question**

Corporate social responsibility (CSR) and environmental, social, and governance (ESG) investing are now embedded in mainstream capital markets. Yet debate persists over whether stakeholder-oriented practices meaningfully influence financial performance. This paper evaluates the empirical evidence and reframes the discussion through a governance lens, focusing on risk, materiality, and institutional conditions.

### **1.1 The Polarized Debate**

Debate surrounding corporate social responsibility (CSR) and environmental, social, and governance (ESG) investing has become increasingly polarized. Advocates often frame ESG as essential to long-term value creation, while critics argue that it dilutes fiduciary focus and introduces political or ideological considerations into capital allocation. This polarization obscures the more fundamental institutional question: under what conditions do stakeholder-oriented practices affect financial outcomes?

In institutional capital settings — including endowments, insurance companies, pensions, hedge funds, private equity, and infrastructure investing — ESG discussions often oscillate between branding narratives and return skepticism. What is often missing is a disciplined examination of mechanism, meaning the specific way in which stakeholder practices may influence financial outcomes — for example through risk reduction, cost changes, or competitive positioning.

For fiduciaries, the relevant issue is not whether ESG aligns with values, but whether it materially influences risk exposure, cash-flow durability, or cost of capital. Framing the debate as binary — ESG either “works” or it “does not” — mischaracterizes the underlying economics. The empirical literature supports conditional effects rather than universal claims.

This paper therefore avoids ideological positioning and instead evaluates the evidence through a governance lens.

### **1.2 Why “Does ESG Generate Alpha?” Is the Wrong Question**

The question most frequently posed in capital markets — “Does ESG generate alpha?” — is narrowly framed. Alpha refers to risk-adjusted outperformance relative to a benchmark. Yet fiduciary responsibility extends beyond short-term excess return.

Boards and investment committees are charged with preserving capital, managing risk, and supporting durable value creation. Many ESG mechanisms operate through risk mitigation rather than systematic outperformance. Environmental compliance systems, safety protocols, supply chain oversight, and governance controls reduce the probability or severity of adverse events. These mechanisms — the pathways through which ESG practices could affect financial outcomes — are better understood as modifications to downside risk than as return enhancers.

In more return-maximizing strategies — such as hedge funds or private equity — ESG considerations are often incorporated opportunistically. If stakeholder practices improve competitive positioning or reduce identifiable risk, they are adopted; if not, they are deprioritized. This reflects economic discipline rather than ideological inconsistency.

Reframing the question shifts the lens from “Does ESG outperform?” to “Through what economic mechanisms might stakeholder practices influence volatility, tail risk, or long-duration cash flows?” That reframing aligns with fiduciary duty.

### 1.3 Reframing as Risk, Materiality, and Governance

To evaluate CSR/ESG rigorously, three dimensions are necessary:

- **Risk exposure** — does the issue alter the firm’s probability distribution of outcomes?
- **Economic materiality** — is the issue structurally linked to industry-specific exposure?
- **Governance integration** — is the risk embedded in oversight and operational systems?

In institutional practice, ESG discussions frequently fail at the economic materiality stage. Boards may review environmental, social, and governance categories generically, without mapping them to asset-level or industry-specific economic exposure. Climate risk, for example, is often discussed at a reputational or portfolio level rather than analyzed asset-by-asset in underwriting models.

Without economic linkage and operational integration, stakeholder initiatives risk becoming narrative commitments rather than components of risk architecture. The remainder of this paper evaluates the empirical evidence through these three lenses.

## 2. What the Evidence Actually Shows

Before turning to mechanisms and governance implications, it is necessary to examine what the empirical literature actually shows. The research does not provide a single definitive answer. Instead, it reveals patterns, limitations, and conditional effects that frame the debate more precisely.

### 2.1 The Meta-Analytic Center of Gravity

Over several decades, researchers have examined the relationship between corporate social performance and financial outcomes. Large-scale meta-analyses synthesizing hundreds of studies report a modest positive association between corporate social performance and financial outcomes (Orlitzky, Schmidt & Rynes 2003; Margolis, Elfenbein & Walsh 2009). The average effect size is small and highly heterogeneous.

This does not imply that ESG guarantees superior returns. It indicates that stakeholder governance correlates with financial performance under certain conditions. Industry structure, measurement choices, and time horizon materially influence results.

The center of gravity of the literature is conditional: modest average association, substantial dispersion.

### 2.2 Measurement Error and Ratings Disagreement

Measurement challenges contribute materially to heterogeneity. ESG ratings from different providers frequently diverge in their assessments of the same firm (Berg, Kölbel & Rigobon 2020). Differences in methodology, weighting, and data construction produce substantial disagreement.

For fiduciaries, this has practical implications. Composite ESG scores may reflect reporting quality or disclosure breadth as much as operational discipline. Aggregating environmental,

social, and governance factors further obscures the specific ways in which each may affect financial outcomes.

In institutional allocation settings, ESG ratings often appear prominently in marketing materials. Yet high ratings do not necessarily indicate embedded risk control. Without examining operational integration, reliance on scores provides false precision.

Measurement noise weakens observed statistical relationships and reinforces the need to examine how specific factors affect financial outcomes rather than relying on broad correlations.

### **2.3 Causality Challenges and Financial Flexibility**

Financially stronger firms often have greater financial flexibility, enabling them to invest in stakeholder initiatives (Waddock & Graves 1997). This complicates efforts to determine whether ESG improves performance, or whether strong performance enables ESG investment.

Cross-sectional associations alone cannot establish directionality. Researchers have attempted to address this using time-lagged analyses and event studies, yet isolating direction of cause remains difficult.

The possibility does not eliminate the potential for ESG to have genuine financial impact. It underscores the need to examine how ESG might influence financial outcomes, rather than relying solely on correlation.

### **2.4 Time Horizon and Aggregation Problems**

Many ESG-related investments generate financial effects over extended horizons (Edmans 2011). Environmental transition investments, workforce development, and supply chain redesign may influence performance over multi-year periods.

Short-term evaluation windows can therefore understate long-duration effects. Firms operating under quarterly performance pressure may underinvest in economically material stakeholder initiatives.

Aggregation across industries introduces further distortion. Environmental exposure is structurally more material in capital-intensive sectors — such as infrastructure and energy — than in asset-light businesses. Pooling such firms can dilute sector-specific relationships.

Measurement error, reverse causality, time horizon constraints, and aggregation effects explain much of the literature's apparent inconsistency. The evidence is mixed not because it is incoherent, but because mechanisms operate conditionally.

**Table 1. Summary of Empirical Evidence on CSR/ESG and Financial Performance**

<b>Evidence Category</b>	<b>Typical Finding</b>	<b>Strength of Evidence</b>	<b>Key Limitation</b>	<b>Fiduciary Interpretation</b>
Meta-Analyses (CSR/CSP & Financial Performance)	Modest average positive association	Moderate (large sample synthesis)	Heterogeneity; correlation $\neq$ causation	ESG not universally value-enhancing; effects conditional
ESG Ratings Disagreement Studies	Significant variation across providers	Strong (methodological clarity)	Measurement noise; aggregation issues	Ratings are screening tools, not decisive indicators
Event / Crisis Studies (“Reputation Insurance”)	Firms with stronger prior CSR suffer smaller negative reactions during adverse events	Strong (event-based methodology)	Contingent; effect visible mainly in downside states	ESG most defensible as downside risk mitigation
Materiality-Based Studies	Financial benefits concentrate in economically material ESG issues	Moderate to Strong	Industry-specific; dependent on classification	Capital discipline requires identifying economically material risks
Governance Integration Research	Operational embedding and oversight mediate ESG impact	Moderate (governance-performance linkage)	Hard to isolate mechanism	Governance quality determines realization
Short-Termism / Horizon Literature	Long-duration investments may be undervalued under short-term pressure	Moderate	Measurement over extended horizons	Capital duration determines ESG payoff

Sources: Orlitzky, Schmidt & Rynes (2003); Margolis, Elfenbein & Walsh (2009); Berg, Kölbel & Rigobon (2020); Minor & Morgan (2011); Khan, Serafeim & Yoon (2016); Edmans (2011).

### **3. The Mechanisms: How CSR/ESG Can Affect Financial Outcomes**

If the aggregate evidence shows a modest and heterogeneous relationship between CSR/ESG and financial performance, the relevant question is: through what economic mechanisms do such effects arise?

Rather than treating CSR/ESG as a single undifferentiated factor, analysis should distinguish among distinct mechanisms. The literature supports three principal mechanisms: (1) downside risk mitigation, (2) strategic materiality and competitive positioning, and (3) governance integration and operational discipline. The strength of each mechanism depends on industry exposure, execution quality, and institutional time horizon.

#### **3.1 Downside Risk Mitigation (“Reputation Insurance”)**

The most consistently supported mechanism is downside risk mitigation. Event-based studies examining corporate crises suggest that firms with stronger prior CSR performance experience less severe negative stock reactions following adverse events (Minor & Morgan 2011).

This has been described as a form of reputation insurance. Stakeholder goodwill accumulated through credible practice may buffer financial damage during crises. This effect is contingent and it becomes visible primarily in adverse states.

Avoiding harm is economically more consequential than visible philanthropy. Firms that publicly promote ESG commitments while tolerating operational weaknesses may not receive protection — and may face amplified penalties.

For institutional allocators, this distinction is critical. ESG positioned as branding without operational embedding provides no insurance. Risk mitigation arises from governance discipline, not narrative alignment.

This mechanism aligns with fiduciary priorities: reducing tail risk affects long-term value even when average returns are unchanged.

#### **3.2 Strategic Materiality and Competitive Context**

Financial impact concentrates where ESG initiatives target economically material exposures (Khan, Serafeim & Yoon 2016). Material issues are those directly linked to regulatory exposure, cost structure, capital intensity, or competitive positioning.

In practice, boards discuss ESG categories broadly rather than mapping them to asset-level economics. For example, climate risk may be addressed in portfolio commentary without evaluating specific asset transition exposure, regulatory jurisdiction, or capital structure sensitivity.

In capital-intensive sectors such as infrastructure and energy, stakeholder risk is inseparable from regulatory and transition exposure. In these contexts, ESG integration is less about signaling and more about underwriting discipline.

Conversely, generic sustainability initiatives with weak linkage to economic drivers do not produce durable financial effects. Strategic materiality aligns stakeholder spending with capital allocation discipline.

### **3.3 Governance Integration and Operational Discipline**

Governance integration determines whether financial effects are realized. Disclosure alone does not alter risk; operational embedding does.

Stakeholder risks must be incorporated into enterprise risk management systems, capital budgeting decisions, incentive structures, and board oversight processes (Eccles, Ioannou & Serafeim 2014).

In institutional settings, ESG frequently appears in standalone reports or marketing materials, but less frequently in underwriting models or compensation structures. Where integration is absent, financial effects are limited.

This reinforces the central theme: ESG's financial relevance depends not on public commitments but on institutional execution.

## **4. Boundary Conditions: When CSR/ESG Does Not Pay**

If CSR/ESG's financial impact is conditional, then underperformance is not an exception—it is a predictable outcome when economic linkage and governance discipline are absent. Clarifying these boundary conditions is essential for fiduciaries. Without them, stakeholder initiatives become symbolic expenditures or marketing overlays rather than components of risk architecture.

### **4.1 Immaterial Issue Spending**

CSR/ESG initiatives that are economically immaterial to a firm's industry exposure do not generate durable financial return.

In institutional allocation contexts, it is common to see ESG commitments framed broadly—covering environmental stewardship, diversity goals, or community engagement—without explicit articulation of how those initiatives connect to revenue drivers, regulatory risk, or cost structure. Without that linkage, stakeholder initiatives do not affect financial performance.

Research distinguishing material from immaterial sustainability issues finds that performance effects concentrate in economically material issues (Khan, Serafeim & Yoon 2016). When firms invest in immaterial domains while underinvesting in economically relevant exposures, expected financial benefit is limited.

This is not a critique of social value. It is a capital allocation issue. Fiduciaries must distinguish between socially desirable initiatives and economically material risk controls.

### **4.2 Disclosure Without Operational Integration**

A second failure mode arises when ESG efforts remain primarily at the level of disclosure.

In institutional settings, ESG is frequently prominent in marketing materials, sustainability reports, and investor communications. Yet operational integration—embedding stakeholder risk into underwriting models, capital budgeting decisions, and executive incentives—is frequently absent.

Measurement disagreement across ESG ratings providers reinforces this concern (Berg, Kölbel & Rigobon 2020). Improvements in reported scores may reflect enhanced disclosure or reporting sophistication rather than meaningful operational change.

For fiduciaries, the distinction is critical. Disclosure enhances transparency; operational discipline alters risk. Without integration into governance systems, financial impact is minimal.

### **4.3 Horizon Mismatch**

Even economically material ESG investments fail to generate observable financial benefits when capital duration is misaligned.

Environmental transition investments, workforce development, and supply chain redesign frequently produce effects over multi-year horizons (Edmans 2011). Firms operating under short-term market pressure may underinvest in such initiatives or be unable to capture their compounding benefits.

Similarly, investment strategies evaluated primarily on short-term relative performance may discount long-duration risk mitigation. In these settings, ESG may be treated as optional overlay rather than structural exposure management.

Horizon alignment is therefore a necessary condition. Without duration of capital and governance patience, even well-targeted stakeholder investments may not translate into observable financial improvement.

### **4.4 Inconsistent Signaling and Credibility Gaps**

A final boundary condition concerns credibility.

Firms that promote stakeholder commitments while tolerating operational weaknesses risk amplified penalties during adverse events. Evidence suggests that reputation functions as protection only when practices are perceived as credible and consistent (Minor & Morgan 2011).

Inconsistent signaling—public commitments unsupported by governance integration—erodes trust more quickly than silence. In institutional allocation settings, such inconsistencies are often revealed only during stress events.

This reinforces a central theme: ESG's financial relevance depends on institutional execution. Narrative alignment without operational alignment does not provide economic protection.

## **5. A Governance Framework for Fiduciaries**

If CSR/ESG's financial relevance is conditional, fiduciaries require structured evaluation. Without such structure, stakeholder initiatives are treated either as guaranteed value drivers or as ideological expenditures.

The framework below synthesizes the preceding analysis into three governance tests: materiality, credibility, and horizon alignment. These are lenses for disciplined oversight—not scoring models and not moral judgments.

## 5.1 The Materiality Test

The first question is economic: Is the ESG issue structurally linked to the firm's industry exposure and business model?

Materiality requires a clear explanation of how the issue affects financial outcomes. Stakeholder risks must connect to regulatory exposure, capital intensity, cost structure, supply chain dependence, or revenue sensitivity.

In practice, boards review ESG categories at a high level without mapping them to asset-level economics. For example, climate risk may be discussed broadly while transition exposure differs significantly across individual assets. Regulatory risk may be referenced without evaluating jurisdictional variation.

A disciplined materiality test requires:

- Identification of economically significant exposures.
- Explicit articulation of how exposures affect revenue, cost, risk, or capital.
- Prioritization based on exposure magnitude.

Without this mapping, ESG initiatives diffuse resources across immaterial domains.

## 5.2 The Credibility Test

The second question is institutional: Are stakeholder risks embedded within governance systems?

Credibility requires:

- Integration into enterprise risk management.
- Board oversight of economically material exposures.
- Alignment with executive incentives.
- Measurable operational metrics.
- Clear accountability structures.

In institutional allocation settings, ESG is frequently positioned as a commitment or value statement. It is rarely embedded into underwriting assumptions, compensation design, or capital allocation models.

Disclosure without operational embedding does not alter risk. Where governance systems incorporate stakeholder exposure into decision-making, financial effects—particularly in downside states—materialize.

This distinction separates branding from discipline.

### **5.3 The Horizon Alignment Test**

The third question concerns duration: Does the institutional structure allow stakeholder investments to compound?

Even when ESG initiatives are material and governance-integrated, realization depends on time horizon. Capital-intensive sectors—such as infrastructure and energy—often operate on long-duration cash-flow models. In these settings, environmental and regulatory exposures are inseparable from underwriting discipline.

Conversely, strategies operating under shorter capital cycles may incorporate ESG selectively, emphasizing exposures with near-term financial impact.

Horizon alignment determines whether ESG functions as structural risk management or peripheral overlay. Fiduciaries must evaluate whether incentive systems, capital stability, and evaluation windows are consistent with the time horizon of stakeholder investments.

Taken together, the materiality, credibility, and horizon alignment tests convert a polarized debate into structured governance analysis. They neither assume ESG superiority nor stakeholder irrelevance. Instead, they treat stakeholder exposure as a conditional component of capital discipline.

## **6. Implications for Boards and Investment Committees**

If CSR/ESG's financial relevance is conditional and mechanism-driven, fiduciary oversight must be equally disciplined. Treating stakeholder initiatives as automatic value enhancers or symbolic expenditures reflects insufficient analytical structure.

For boards and investment committees, the operative question is not whether to endorse ESG, but how to evaluate economically material stakeholder exposure within the broader framework of risk oversight and capital allocation.

This requires moving beyond narrative positioning to structured inquiry.

### **6.1 Questions Boards Should Ask**

Boards should begin with exposure clarity rather than generalized commitment. A disciplined discussion may include questions such as:

- What are our most economically material stakeholder risks given our industry structure, regulatory environment, and operating footprint?
- Where are we exposed to asymmetric downside events — regulatory penalties, operational failures, litigation, or license-to-operate risks?
- Are these exposures explicitly incorporated into enterprise risk management systems?
- How are ESG-related metrics linked, if at all, to executive incentives and capital allocation decisions?
- Where might we be allocating resources to immaterial initiatives while underweighting economically significant risks?

- How would these stakeholder exposures behave under credible stress scenarios?

These questions shift ESG from value signaling to risk architecture. They also reinforce fiduciary responsibility: stakeholder governance is relevant when it is economically consequential.

## **6.2 Interpreting ESG Ratings**

Investment committees frequently encounter ESG scores in manager presentations, portfolio screens, and benchmarking exercises. These inputs are informative but require disciplined interpretation.

Given documented disagreement across ratings providers and limited methodological transparency (Berg, Kölbel & Rigobon 2020), ESG scores should be treated as screening inputs rather than conclusive assessments of risk quality.

Committees should distinguish between:

- Relative positioning within a ratings framework,
- Underlying operational practices,
- And industry-specific economic exposure.

High scores may reflect disclosure sophistication. Low scores may reflect methodology differences rather than unmanaged risk. Ratings provide signals; they do not substitute for governance analysis.

## **6.3 When to Discount ESG Claims**

Boards and ICs should discount stakeholder claims where execution is unclear.

Indicators of superficiality may include:

- Extensive sustainability disclosures without measurable operational KPIs.
- Public commitments not reflected in capital budgeting decisions.
- Material regulatory or environmental exposure lacking dedicated oversight structures.
- ESG positioning disconnected from asset-level underwriting.

In institutional settings, ESG often appears prominently in marketing materials, particularly within private market strategies. Fiduciaries must distinguish between signaling alignment and demonstrable risk control.

This is not skepticism toward ESG as a concept. It is skepticism toward unverified integration.

## **6.4 When to Underwrite ESG as Structural Risk Control**

Conversely, there are contexts in which stakeholder governance warrants explicit underwriting as part of structural risk management.

These may include:

- Capital-intensive industries with regulatory or environmental exposure.
- Infrastructure and energy assets subject to transition risk.
- Businesses dependent on long-duration licenses or public trust.

- Supply chains exposed to geopolitical or labor instability.

In these settings, stakeholder exposure is inseparable from economic durability. ESG integration may therefore function less as optional overlay and more as core underwriting discipline.

The objective is not to elevate ESG above financial analysis. It is to incorporate economically material stakeholder risks into the same structured evaluation applied to leverage, liquidity, and competitive positioning.

This section reinforces the central thesis: CSR/ESG should be neither romanticized nor dismissed. For fiduciaries, it is a structured risk and governance question. Its financial relevance depends on exposure magnitude, execution credibility, and capital duration.

## **7. Conclusion — A Governance-Centered Position**

The debate over CSR and ESG has too often been framed as a question of belief rather than governance discipline. The empirical literature does not support universal claims of systematic outperformance. Nor does it support dismissal of stakeholder exposure as financially irrelevant.

The evidence instead indicates that stakeholder governance affects the distribution of financial outcomes under identifiable conditions. The most defensible mechanism is downside risk mitigation. Material exposure determines where that mitigation is economically relevant. Governance integration determines whether it is realized. Horizon alignment determines whether it compounds.

For fiduciaries, the implication is structural rather than ideological. Economically material stakeholder risks belong within formal risk oversight. Where exposure is significant, treating ESG considerations as peripheral reflects incomplete governance.

CSR/ESG is neither a guaranteed source of excess returns nor a marketing category. It is a conditional component of capital discipline. Institutions that approach it with structured analysis—mapping materiality, embedding governance, and aligning duration—are better positioned to preserve durability in uncertain environments.

A governance-centered interpretation moves the discussion beyond advocacy and skepticism. It restores the debate to fiduciary clarity.

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