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# Does Corporate Social Responsibility affect Corporate Financial Performance?

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***ABSTRACT:*** *Corporations are not only obliged to perform economic and legal activities but also to work for betterment of society at large— through donations or workplace improvement. Involvement in corporate social responsibility (CSR) brings costs for corporations. Managers' concerns call for the shareholders' maximum worth and if CSR does not foster corporate financial performance (CFP), which in turn maximizes value of shareholders, it becomes a matter of serious attention for managers. Therefore, the study of the relationship between CSR and CFP is a very important area for firms who are involved or tend to get involved in CSR activities. Literature does not contain very extensive research on this topic and many studies on this topic have varied results in this regard—hence, do not provide a clear picture of CSR & CFP relationship. This review paper attempts to find out reasons for such differential results using meta-analysis. Study includes analysis of seven research articles; three seminal research pieces and four highly cited papers from last five years. Research articles were compared and analyzed on the basis of methodology, measures used for quantifying CSR & CFP to withdraw results. The study concludes that CSR is a construct variable having a tint of subjectivity. Due to this subjectivity of CSR, a certain relationship may not be established between CSR & CFP.*

**Keywords:** CSR, CFP, shareholders worth, meta-analysis, corporate managers.

McGuire (1963) said, "The idea of social responsibilities supposes that the corporation has not only economic and legal obligations but also certain responsibilities to society which extend beyond these obligations." The issue is whether corporations being socially responsible pose only costs to the corporations or if this otherwise helps to enhance corporate financial performance (CFP). The debate about the relationship between CSR and CFP started in the earlier 1960s but it gained steam after the arguments made by Friedman (1970) that businesses have only one responsibility and that is to indulge in only those activities which generate profits by utilizing all of their resources. The relationship between CSR and CFP became a critical issue for corporate management. So, researchers started to scrutinize the relationship between CSR and CFP -- either CSR increases CFP or it does not, and if CSR does so, this will motivate corporations to besocially responsible and engage in activities for the betterment of the society at large. If the relationship is negative, corporations should be cautious about CSR activities. Many studies have been carried out in this respect most of them in developed regions such as United States of America and United Kingdom but few have been done in developing regions such as South Asia, specifically in Pakistan. Before conducting a study aboutthe relationship between CSR and CFP, it is cardinal to first review the existing literature and the contemporary debate/study on this topic. I have selected three seminal research pieces and four contemporary research articles from the existing literature. Seminal and current research articles for review paper are considered on the following criteria.

Seminal Research Articles:

- Cited by at least 750 researchers
- Published in a journal having impact factor indexed by Thomson Reuters or had been published in the journal that is hosted by a well reputed and prestigious host body such as Elsevier, Springer, J-Store, Wiley Online Library etc.
- One research article from the decade1991-2000 and two from 1980s era.

Current Research Articles:

- Published in Last 5 Years
- Published in a journal having impact factor indexed by Thomson Reuters or had been published in the journal that is hosted by a well reputed and prestigious Host body such as Elsevier, Springer, J-Store, Wiley Online Library etc.
- Two articles on developing regions and one on developed regions
- Different industries
- Articles before 2012 cited by at least 50 researchers along with impact factor.
- Articles after 2012 having impact factor.

### Ontology

What is Corporate Social Responsibility (CSR)?
What is Corporate Financial Performance (CFP)?

### Epistemology

CFP is an objective measure because we can prove it on basis of facts and figures and can conclude whether financial performance is good or bad. CSR, on the other hand, has a tint of subjectivity. For example, if a corporation ABC gives a donation of PKR 100,000/- and another corporation XYZ give PKR 2,000,000/- for the betterment of society. The LMN society may consider both corporations as equally socially responsible and the ORS society may consider XYZ more socially responsible as it donates more money.

### Research Gaps Identified relating to CSR and CFP Relationship

Cochran and Wood (1984) tested the relationship between CSR and CFP empirically. They looked at several previous studies and found defects both in the tools used to measure CSR and CFP and the sample size. Bragdon and Marlin (1972), Folger and Nutt (1975) and Sturdivant and Ginter (1977) measured CSR by Reputation Index using small sample size for indexing, which adds an additional tint of subjectivity. Bowman and Haire (1975), Ingram (1978), Preston (1978), Anderson &Frankle (1980) used Content Analysis for measuring CSR but also had drawbacks. Yet no better measure was available. On other hand, there is no consensus among researchers about how to measure CFP.

Some studies utilized investor returns (change in price per share, dividend income etc.) Moskowitz (1972) & Vance (1975) measured only by change in share price. Abbott and Monsen (1979) measured by change in price per share along with dividend income. All the previous studies ignored the volatility of the returns i.e. Risk. Attempts were made to test the relationship by integrating impact of risk factor e.g., Ingram (1978) but no significant results were found to better define the relationship between CSR and CFP. On the other side, some researchers tried to measure CFP through Accounting Returns (price/earnings ratios and earnings per share) e.g. Bowman and Haire (1975), Heinze (1976) and Spicer (1978) but no significant results found. Furthermore, Cochran and Wood argued that the previous studies tested the relationship choosing sample sizes too small, which also contributed to the insignificant findings.

J. B. McGuire et al (1988) identified that earlier studies had ignored the reputation of socially responsible corporations for which they utilized Fortune Survey for the first time to examine the relationship between CSR and CFP. Secondly, they measured CFP by incorporating risk factors. Thirdly, they also tried to find out the impact of CFP on CSR. McWilliams and Siegel (2000) said existing literature had several limitations regarding the research model and variables incorporated in each study. Prior studies missed some significantly important determinant(s) of CFP such as research & development. They discussed research and developments' correlation with CSR and tried to develop the appropriate estimate to test, effect of CSR on CFP.

Lin, Yang, and Liou (2009) said to identify the relationship between CSR and CFP, very little, next to nothing has been found in the literature in the context of Taiwan. They embarked to find relationship between CSR, Consumer Behavior and CFP. They argued that econometric models are not properly specified, as they overlooked some variables which are considered very important for determining firms' profitability such as intensity of firms' investment in research and development. Several studies showed that long-term CFP is enhanced by investing in research development. So overlooking especially investment in research and development in econometric models creates problem in determination of CFP and CSR relationship.

Inoue and Lee (2011) studied the previous research concerning CSR and CFP linkage and found that CSR was measured as an aggregate of all CSR activities. They elucidated that more refined and appropriate results can be found by disaggregating CSR into five primary issues of stakeholders: (i) Community Relations, (ii) Consumer Relations (product quality as its proxy), (iii) Environmental issues, (iv) Employee Relations and (v) Diversity Issues. They tested the impact of above mentioned issues separately, one by one on short and long-term CFP.

Mustafa, Othman, and Perumal (2012) identified four relationships between the three factors: CFP, Reputation and CSR. First, good CFP stimulates the corporations to be socially responsible which ultimately improves its reputation. Second, good CFP boosts up the corporations' reputation, stimulating it to perform social activities. The third relationship indicates interplay of three factors. Lastly, CSR increases corporations' reputation and hence increased reputation positively impacts CFP. Many studies have explained the first three perspectives but little has been done in regards to the last perspective. That's why this study has examined the fourth perspective of CFP, reputation and CSR in the context of Malaysian public limited companies.

1. CFP-CSR-REPO
2. CFP-REPO-CSR
3. Interplay of Three Factors
4. CSR-REPO-CFP

Ahamed, Suhazeli, Almsafir, and Al-Smadi (2014) disaggregated the CSR in four key activities, i.e. doing things for the betterment of community, employee workplace, marketplace and environment to ascertain the CSR & CFP linkage. They argued that body of literature is silent about the certainty of positive linkage between CSR & CFP, especially PLCs in developing countries.

For differences in Measuring CSR (Independent Variables)Cochran and Wood (1984) utilized Moskowitz's list (reputation index), which was being widely used in several previous studies to measure CSR. J. B. McGuire et al (1988) utilized Fortune Survey to measure CSR and argued that it's best for a long period because it offers comparable respondents and data. Furthermore, the survey contained key and critical data for CSR, which is not easily available in reports generated annually regarding financial position and in other internal documents. McWilliams and Siegel (2000) used CSR information about 524 companies provided by a firm KLD because they evaluated the corporations on the basis of 11 elements for being a socially responsible corporation. CSR is taken as dummy variable; socially responsible firm is given value 1 and not socially responsible is given value 0. Lin et al. (2009) used donation ratio of company as a proxy variable for measuring CSR. Inoue and Lee (2011) used five socially responsible activities, each of them as proxy for CSR and they arranged the data from KLD which maintains a data-base for socially responsible corporations. Mustafa et al. (2012) disaggregated CSR in four instincts (legal, philanthropic, economic and ethics); these were used as proxy for CSR. Ahamed et al. (2014) identified four dimensions of CSR, refined the PLCs which were involved in these four socially responsible actions, and used these dimensions as proxy variable of CSR.

For differences in Measuring CFP (dependent Variables) Cochran and Wood (1984) brought novelty in literature using new a measure called "Excess Value" along with Accounting Returns (Operating Income to Sales ratio & Operating Income to assets ratio). J. B. McGuire et al. (1988) measured CFP on the basis of stock market performance measures (total return and alpha; risk adjusted return), accounting returns (operating income, debt/asset ratio and operating leverage) and risk (systematic risk; beta). McWilliams and Siegel (2000) took the long term financial performance measured by the accounting returns as utilized by Cochran and Wood (1984). Lin et al. (2009) used accounting returns (return on asset) measuring short-term (one year) CFP. For measuring long-term (3 year) CFP, five CFP indicators -- Jenson, Treynor, Amended Jenson, MCV and Sharpe -- were utilized. Inoue and Lee (2011) used Tobin's Q formula as a measure of long-run CFP and accounting return (ROA) for measuring short-run CFP. Mustafa et al. (2012) measured CFP utilizing 6 factors derived from two studies; Sin et al. (2006) and Olalekan (2011). Ahamed et al. (2014) utilized accounting returns (Return on Firms' Equity and Return on Firms' total assets) because this measure had been widely recognized as appropriate for representing CFP and utilized in much of the studies.

**Table 1: CFP and CSR Measures**

| Researcher(s) | CFP Measure | CSR Measure |
|---|---|---|
| Cochran and Wood (1984) | Accounting Returns, Excess Value and Asset Age | Proxy/Dummy |
| J. B. McGuire et al.(1988) | Accounting Returns, Accounting Returns (Risk Adjusted) and Measures of Stock Market Performance. | Proxy |
| McWilliams and Siegel (2000) | Accounting Returns | Proxy |
| Lin et al. (2009) | Accounting Returns along with *Jenson, Treynor, Amended Jenson, MCV and Sharpe measures.* | Proxy |
| Inoue and Lee (2011) | Accounting Returns and Tobin's Q formula | Proxy |
| Mustafa et al. (2012) | 06 factors Derived from; Sin et al. (2006) and Olalekan (2011) | Proxy |
| Ahamed et al. (2014) | Accounting Returns | Proxy |

## Methodological Review

Cochran and Wood (1984) examined the phenomena deductively and tested the relationship using two statistical tools, developing research questions rather than hypotheses. Firstly, they applied regression on variables (dummy variable on behalf of CSR), tested CSR with the covariance analysis and matched the results with previous studies. They then used another statistical tool that had never been applied to test the relationship i.e. Log-it Analysis. He eliminated the flaw of short sample size; selected two time periods (1970-1974 and 1975-1979) to increase sample size, 39 corporations from 29 industries of 1970-1974 and 36 corporations from 28 industries of 1975-1979. These corporations were compared with 386 and 366 corporations respectively with control groups of their industries. McWilliams and Siegel (2000) improved the econometric model that was proposed and used in several studies by incorporating variables research and development and industry factor to argue that the previous model was not appropriate as it ignored important variable research and development due to which varied results were generated. Secondary data was utilized to develop research questions. They took a sample of 524 firms from the KLD data for the period of 1991-96 as an average annual value and applied regression. Secondary data was utilized. Lin et al. (2009) developed questionnaire and gathered primary data about CSR by conducting a survey. For CFP, secondary data was utilized. They selected Taiwan's 33 corporation from 1000 corporations evaluated as socially responsible by "Common Wealth Magazine" based on the criteria that it should be listed on Taiwan stock exchange, be in top (top 200 manufacturing, top 500 services & 100 financial institutions) and have donated NT\$2.5 (M) in 2003.

Financial data was selected for 2002-04. Data was analyzed by regressing for short term and long term CFP and dividing the companies into two sectors: manufacturing corporations and non-manufacturing corporations. Inoue and Lee (2011) gathered the data of 4 industries (59 casinos, 183 restaurants, 74 airline and 51 hotels) related to tourism sector about CSR from KLD data-base and for CFP, from the analysis COMPUSTAT database from 1991-2007. First, they checked the normality of variables by natural log-transformation and eliminated the outliers for regression. They tested homoscedasticity by Lagrange-Multiplier, and then errors' independence was checked by Durbin-Watson formula. Further, to control Standard Error, OLS method and Newey West method were utilized. Then they applied a regression model taking CSR as independent variable and CFP as dependent variable. Mustafa et al. (2012) developed a questionnaire and conducted survey for getting CSR data of 200 public limited companies (PLC). The Questionnaire was made internally reliable by testing it through interviews with the top management of 40 top PLCs. Reputation was measured through Five-Point Linker Scale. Then a confirmatory analysis was carried out to check the fit of model and variables. They developed three hypotheses and tested the mediating effect of reputation on CSR and CFP by applying regression techniques to the data with the help of SPSS version 17.0 AMOS. Ahamed et al. (2014) developed hypotheses which were tested by two theoretical frameworks: 1) By analyzing the relationship between CSR and CFP without incorporating any control variable through regression using SPSS and 2) By two control variables (total sales of firm and size of firm in terms of no. of employees) incorporated along with CSR & CFP. The secondary data was utilized and gathered from annual reports of three large PLCs listed at KLSE from year 2007 to year 2011 both for CSR and CFP.

**Table 2: Methodical Review**

| Researcher(s) | Qualitative Study / Quantitative Study | Deductive / Inductive |
|---|---|---|
| Cochran and Wood (1984) | Quantitative | Deductive |
| J. B. McGuire et al.(1988) | Quantitative | Deductive |
| McWilliams and Siegel (2000) | Quantitative | Deductive |
| Lin et al. (2009) | Quantitative | Deductive |
| Inoue and Lee (2011) | Quantitative | Deductive |
| Mustafa et al. (2012) | Quantitative | Deductive |
| Ahamed et al. (2014) | Quantitative | Deductive |

### Comparison of Research Settings

Cochran and Wood (1984) did not focus their study on any specific industry but instead used a pool of corporations and compared them against the industrial control groups from Standard and Poor's list from within United States of America. J. B. McGuire et al (1988) also did not focus on any specific industry but country (America) and used the data provided by Fortune Survey about companies engaged in CSR. McWilliams and Siegel (2000) did not run their model focusing on a specific industry but selected 524 corporations of different sectors from the United States of America. Lin et al. (2009) selected 33 corporations from Taiwan (developed country) and did not focus on a specific industry or sector. Inoue and Lee (2011) focused their study on 4 industries (casinos, restaurants, airline and hotels) related to tourism sector from the United States of America (developed country). Mustafa et al. (2012) undertook public limited companies of Malaysia for their study without focusing on a specific sector or industry. Study was conducted in Malaysian context (developing country) and cannot be generalized to the other geographical parts of world. Ahamed et al. (2014) used PLCs listed at KLSE for the study without distinguishing any industry or sector. Further study has its implications only for developing countries.

### Comparison of Directions for Researchers

Cochran and Wood (1984) suggested that it will be more valuable to measure CSR subjectively rather than objectively for time series data with the help of perceptions of CSR because it will provide an index more consistent with the data. Furthermore, they proposed that new variables should be sought and additional factors affecting asset age used in this study should be identified. J. B. McGuire et al. (1988) suggested that better results would be generated if future studies investigate the effect of previous CFP on CSR rather than testing effect of contemporary CSR on CFP. Also, new measures should be identified rather than incorporating the same measures used in previous body of literature, so that the bias in results created by mono measures could be eliminated or lessened. Lin et al. (2009) study can be extended in other contexts or in other countries, suggesting that incorporating environmental and organizational factors in the model can be very fruitful in determining the CSR and CFP relationship. Further, they suggested other organizational outcomes resulting from CSR, as dependent variable would be more appropriate rather than CFP. Inoue and Lee (2011) said that additional factors other than those introduced in the study may be considered for future research. CSR is a construct variable, objective measures can be found in future and will improve the results along with testing the reverse relationship i.e. effect of CFP on CSR. According to Mustafa et al. (2012), small medium enterprise (SME) sector is emerging and competition is becoming stiffer, future research could be conducted on this sector in Malaysia utilizing a large sample size. Ahmed et al. (2014) study can be extended by increasing sample size, exploring new factors critical for examining the linkage and focusing on some specific sector(s). Further, private sector may also be studied instead of only PLCs.

### Comparison of Limitations

Cochran and Wood's (1984) study showed that relationship between CFP and CSR is highly significant for the asset age factor which is the opposite of results found in most studies in the body of literature. Thus, its implications are needed to be explored. For J. B. McGuire et al. (1988) suitability and effectiveness of Fortune Survey is needed to be examined because the results may be influenced by the biases of survey evaluators along with the paradigm and purpose for which Fortune survey was carried out. As for Lin et al. (2009), no objective measure of CSR was available leaving the study to be entirely dependent on the respondents, who may have possibly exaggerated their respective companies' commitment to CSR. Only large size firms were included in the study limiting results' implication to small size firms in Taiwan. The results could have been affected by not including potential industry impacts in the model. Various limitations were found for Inoue and Lee's study (2011). The database KLD endures limited construct validity, while evaluating the CSR activities most of the times binary values were assigned to them which caused weight problems, sample size was small, during the study period, the influence of merging firms from the sample were not considered and introducing other mediating factors can provide more realistic results. Finally impact of CFP on CSR should also be identified which was missing in this study. Mustafa et al. (2012) did not embark on SME and private sector. Furthermore, the study was carried out with a small sample size, whereas results could be enhanced by using a large sample size. Ahamed et al. (2014) study utilized and focused only on accounting returns and only two measures were used. The results could be more accurate by incorporating content analysis. The sample size was small. Further the results of study cannot be generalized to all sectors and developed areas.

## Comparison of Results

Lin et al. (2009), Mustafa et al. (2012) and Ahamed et al. (2014) found that both CSR and CFP were significantly correlated. J. B. McGuire et al. (1988) found that Account Returns were positively correlated; CSR enhances CFP and accounting returns (Risk Adjusted) were negatively correlated. Inoue and Lee (2011) found that each of CSR dimension was having differential link with CFP; community and product dimension affect CFP positively. Diversity and environment do not affect CFP positively, thus results were differential. McWilliams and Siegel (2000) concluded that CSR and CFP are independent of the effects of each other CSR does not influence CFP and good CFP does not influence corporations to be involved in social activities. Cochran and Wood (1984) concluded that the linkage between CSR and CFP is not significant which implies that CSR does not foster CFP.

**Table 3: Review of Results**

| Researcher(s) | Results |
|---|---|
| Cochran and Wood (1984) | Insignificant |
| J. B. McGuire et al.(1988) | Positive with accounting returns, Negative for risk adjusted |
| McWilliams and Siegel (2000) | Neutral |
| Lin et al. (2009) | Negative in Short run & Positive in Long Run |
| Inoue and Lee (2011) | Differential with each CSR dimension |
| Mustafa et al. (2012) | Significantly Positive |
| Ahamed et al. (2014) | Significantly Positive |

## Conclusion

Research articles are analyzed by comparing what gaps they identified in the existing literature, what methodologies they opted for in their study, what measures were selected for quantifying CSR and CFP and results of the studies. Studies, under-analysis, were carried out for providing a certain linkage of CSR and CFP so that managers could be able to take better decisions. Studies used quantitative research design and tested the theory (deductive) using statistical tools on secondary data except Mustafa et al. (2012), who conducted survey analysis and used primary data. Use of accounting returns for measuring CFP is common among the under-analysis studies. But proxies used for CSR are different in each of the studies. All utilized regression technique either for answering their research questions or developed hypotheses.

This paper founddifferences in choosing CSR proxy, sample size and country under-study but the main difference found is CSR proxy selection or identification.The results of the studies under-analysis vary. McWilliams and Siegel (2000) argued that variation in results was mainly due to that econometric models were not appropriate as they overlooked some important indicators of CSR. Other researchers also used different dimensions for quantifying CSR taking them as its proxy. CSR is a construct variable because it has a tint of subjectivity as in under-analysis studies researchers identified and utilized different CSR dimensions.Because of its subjective nature prior studies and forthcoming studies may not be able to identify a certain relationship. The uncertainty about the relationship can only be eliminated if it could be possible to measure CSR objectively.

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