Impact of Corporate Social Responsibility Initiatives on Financial Performance of Firms

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ABSTRACT

Corporate social responsibility initiatives have been prevalent in many countries for several years now. In India, many companies have been active in this area even before it was mandated through the Company Law. This study is an attempt to document various researches that have been conducted with respect to relationship between corporate social responsibility initiatives of organisations and their financial performance. The findings from these studies have been mixed. Some studies have reported positive impact on performance of firms while others have found no relationship between CSR initiatives and firm performance. In this context, a review of researches done throws light on methodologies used by researchers to study the relationship between CSR initiatives and firm performance, the manner in which CSR initiatives manifest themselves in improved financial performance and whether CSR initiatives will have a positive impact on financial performance of firms or not.

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Key Words : Corporate Social Responsibility, Financial Performance

1. Introduction

Corporate Social Responsibility is a concept whose origin can be traced to the 1800s. The present form of CSR can be attributed to 1950s and later. There have been many arguments favouring corporates being responsive to society’s needs and many arguments that corporates are responsible only for looking after their shareholders’ interests and not that of the society. In fact, way back in the 1880s, a court decided that the proposed action of a company to compensate its employees for loss of their jobs on its dissolution was against the interests of its shareholders. In contrast, around the same time, a court allowed a company to buy a piece of land for constructing a church, a school and a library for use by its employees stating that it was part of employee welfare measures and will go towards the benefit of the company.

The famous and oft cited article “The Social Responsibility of Business Is to Increase Its Profits” published in 1970 by Milton Friedman argues that the executives in a firm are accountable to the owners of the firm and they have to carry out the dictates of the owners. When the business is set up for making profits, the executives have to ensure that the resources of the firm are deployed to make profits for the firm. In this situation, he argues that, firms cannot cater to social needs and cannot utilise their resources in activities that serve social goals. On the other hand, he also argues that, if a firm is set up for running a hospital or school with charitable intentions, then the duty of the executives of the firm is to abide by the directions of the owners in this regard.

The above idea stems from the ‘agency theory’ i.e. the executive of a firm is an agent of the owner of the firm and his primary responsibility is to the owner of the firm.

But this view has been slowly getting replaced with the view that companies are responsible for all its stakeholders and not just its shareholders.
A view that is against the ‘agency theory’ is the ‘stakeholder theory’. Proponents of this theory put forth the arguments that a firm is also responsible to various other stakeholders without whom the firm cannot function. These stakeholders include employees, customers, suppliers, lenders and society. (Freeman and Reed, 1983).

The current view appears to be that companies need to be responsive to the needs of its employees, the members of the society of which it is part, to the Government, to its customers, to consumers of its products, to its lenders and to its shareholders.

This obviously involves additional costs. When corporates need to be responsive to various stakeholders, they need to incur additional costs. These additional costs may be incurred with respect to employee welfare, environment friendly practices or other activities that benefit society. And for CSR to impact financial performance positively, it is imperative that benefits from CSR are more than the additional costs incurred for CSR activities. (Becchetti et all, 2005). These benefits are expected to be derived from positive perceptions of consumers and other stakeholders who deal with the corporate and from improved employee productivity.

In a survey conducted by Reputation Institute (a private global consulting firm in New York) among 47,000 consumers across 15 markets, it was found that consumers ranked the reputation of the companies higher than the quality of their products. They showed their preference to buy products of those companies that were socially responsible in terms of supporting good causes, following ethical practices and treating its employees well.

Many researchers have studied the impact of a firm’s CSR activities on its financial performance. As of 2013, these studies have been going for more than 40 years but there still appears to be no consensus opinion on the impact of CSR activities on a firm’s financial performance.

The current study attempts to review the literature on the subject to give a perspective of the nature of research studies that have been done in this area. The current study does not attempt to cover all research papers that have been published on the subject. Studies that bring in different perspectives and different aspects have been considered for the review. Studies done abroad and in India have been included for this review.

2. Background

In the current study, an attempt has been made to analyse select research papers spread across the period from the 1970s till date. Research papers covering different facets of the relationship between a firm’s CSR activities and its financial performance have been considered for the current study. Also, studies done abroad and in India have been considered. It is hoped that the research papers studied are representative of the studies done on the subject.

This section summarises the major findings from the papers reviewed. It also highlights a few other aspects pertinent to these research studies. The next section, gives details of the research papers that have been reviewed.

Findings from research studies on the impact of corporate social responsibility initiatives on financial performance of firms can broadly be classified into three classes, namely those that find that there is a positive impact, those that find that there is no impact and those that find that there is a negative impact. The difference in findings may be due to differences in periods for which the studies
were conducted, the financial parameters considered for the studies, the nature of companies considered and the methodologies used.

These studies attribute one of the causes for the positive or negative impact of CSR on financial performance to costs incurred by the firm on CSR. Some studies conclude that firms that involve in social activities incur costs and this leads to a decline in profits. Some other studies find that these costs are not significant and that they actually improve the morale of the employees and thus their productivity. A third viewpoint is that though costs may be incurred in socially responsible activities, other costs incurred by the firm reduce due to these CSR activities.

Another facet of these studies is that there appears to be a circular relationship between CSR initiatives and firm’s financial performance. Good financial performance appears to lead to higher level of CSR activities. And, higher level of CSR activities appear to result in improved financial performance. There appears to be a virtuous circle of financial performance leading to CSR and CSR impacting financial performance. Thus, CSR activities could be considered as both a predictor and a consequence of financial performance. (Waddock and Graves, 1997).

Recently, in March 2013, Kellogg Insight carried an article by Thomas Lys, James Naughton and Clare Wang titled “Pinpointing the value in CSR”. In this article, the authors propose that higher CSR spend, particularly, higher spend than what investors expect, has a signalling effect. According to them, higher CSR spend is a signal to the investors that the firm is expected to perform better in future and, hence, it has increased its spend on CSR.

The causes for an impact on financial performance of CSR activities can be classified broadly into three classes, namely, those relating to perception of employees, those relating to perception of consumers and those pertaining to perceptions of other stakeholders such as suppliers to the firm. Studies have been conducted that find that productivity of employees generally improve when they perceive their employers do be doing good to society and to the employees. Higher productivity results in higher sales per employee (Becchetti et al., 2005). Studies that have analysed the behaviour of consumers find that consumers tend to buy products of firms that are socially responsible thus increasing sales and giving the firms a competitive advantage (Servaes and Tamoya, 2013, Bhattacharya and Sen, 2004). The third view that prevails is that stakeholders such as the suppliers would be willing to negotiate with firms that are seen to be socially active (Becchetti et al., 2005).

Weber (2008) has analysed various research studies on this subject and classified ways in which corporate social responsibility initiatives have an impact on a firm’s financial performance into four classes. They are : (a) positive impact on firm’s image and reputation thus enhancing the firm’s competitiveness (b) positive effect on employee motivation, recruitment and retention (c) positive effect on sales of firm’s products due to positive perception of consumers and (d) reduction or avoidance of CSR related risk such as negative publicity due to lack of CSR initiatives.

Of pertinence in this context is that the positive perception of consumers can come only through awareness about the firm’s CSR activities. Servaes and Tamoya (2013) link the positive impact of CSR on financial performance to the awareness of the firm and its activities among the consumers.

Mishra and Suar (2010) attribute the following to a positive impact on a firm’s financial performance. CSR measures towards a firm’s employees reduces employee turnover and reduces recruitment and training costs. Suppliers who are happy with a firm help in reducing quality related costs for the firm.
A major concern of most studies is the methodology to measure CSR activities. CSR activities take many forms. It is not always possible to quantify CSR activities in monetary terms. In the absence of such monetary measures, researchers have to depend on other measures. Researchers have adopted various measures such as ratings by reputed surveys, rankings by reputed organisations and other measures.

Similarly, there is no consensus on measuring financial performance of firms. Researchers use broadly two classes of financial measures. One class is related to accounting based measures such as Return on Assets (ROA), Return on Investment (ROI), Return on Sales and others. The other class relates to market based measures such as total return to the shareholders.

In this context, a word on research methodologies used by the researchers may be appropriate. The researchers have used research methodologies varying from simple comparison of the relevant parameters of the two groups of firms, namely, those that are socially responsible and those that are not, through correlation and regression analysis to time series analysis.

3. Outline of the Review
The review covers studies with the following four sets of findings:
   i) Studies that have found a positive impact of a firm’s CSR activities on its financial performance
   ii) Studies that have found no impact
   iii) Studies that have found negative impact and
   iv) Studies that have related findings

4. Review of studies
4.1 Studies that have found a positive impact
Waddock and Graves (1997) found that better financial performance resulted in a firm being socially responsible and a socially responsible firms reaped financial benefits. In other words, they found a circular relationship between CSR initiatives and firm’s financial performance. To measure CSR activities, the researchers constructed their own index based on the eight parameters used by the firm Kinder, Lydenberg and Domini (KLD). They used this index to rate firms on corporate social performance. Financial performance was measured by Return on Assets (ROA), Return on Equity (ROE) and Return on Sales (ROS). A total of 469 companies during the period 1989 to 1991 were considered for the study.

Mishra and Suar (2010) studied the effects of CSR activities of firms on their financial performance and non-financial performance. For this study they surveyed 150 senior level executives to seek their opinions on various aspects relating to CSR and non-financial performance. For financial performance, they relied on secondary data. They identified six classes of primary stakeholders, namely, employees, customers, investors, suppliers, community and natural environment. They studied the impact of CSR activities for each of these six primary stakeholders on the financial performance of the firms. To assess whether or not firms were socially responsive they developed their own list of 61 parameters. To assess financial performance, industry-adjusted ROA was used. Based on their study, they find that CSR activities have a positive impact on a firm’s financial performance.

Govindarajan and Amilan (2013) studied different aspects of financial performance of companies in the oil and gas products industry in India that were active in the CSR area. One of the aspects they considered was the impact of Corporate Social Performance (CSP) score on EPS of the
companies. The sample comprised 12 companies from the industry and the analysis was done based on data for four years from 2007 to 2010. To measure CSR, they used three parameters, namely, the rating given by Karmayog, an NGO that rates companies on their CSR activities, the amount of CSR spend and the focus area of CSR. The finding from the study with respect to the aspect mentioned above is that there is a significant positive impact of CSR initiatives on EPS of the companies.

Ghosh (2013) has studied the effect of CSR initiatives on financial performance of Indian companies. She has studied 200 companies listed in the National Stock Exchange of India. The period of study is four years from 2009 to 2012. The criterion for selection of the companies was their market capitalisation. She has chosen top 200 companies by market capitalisation. She has used S&P ESG India index to measure CSP of the companies. She divided the companies into two groups, namely those companies which appeared in the ESG index and those that did not appear in the index. To measure financial performance, she has considered both accounting based and market based measures. For accounting based measures, she has used ROA and ROE and for market based measure, she has used Tobin’s Q. The market based measure is further explored using Ohlson’s valuation model. She concludes based on her findings that superiority in CSR leads to superior financial performance.

4.2 Studies that have found no impact

McWilliams and Siegel (2000) in their study of impact of CSR on financial performance of firms found that the impact is neutral. They argued that earlier studies had omitted the impact of R & D investment on financial performance. In their opinion, R & D investment was an important factor in determining financial performance of firms. They hypothesized and proved that CSR and R & D investment have a strong correlation and so when R & D investment is omitted, CSR appears to have a positive impact. When R & D investment is included in the analysis, the impact of CSR is reduced and the resultant effect is neutral. Their study involved data of 524 firms over the period 1991 to 1996. These were firms that were included in the Domini 400 Social Index (DSI 400).

Aggarwal (2013) has studied the relationship between CSR and financial performance. She has considered both accounting based measures, namely, sales, ROA and ROE and market based measures, namely, PE ratio and Beta to measure financial performance. To measure CSR, she uses CRISIL’s ESG index. Her findings are that sales of companies with high ESG scores are higher than those companies with low ESG scores and that there is no significant difference between companies having high ESG scores and low ESG scores with respect to other measures namely, ROA, ROE, PE Ratio and Beta. She has used data from 100 Indian companies for five years from 2008 to 2012.

4.3 Studies that have found a negative impact

Becchetti et all (2005) in a study of 1000 companies over a period of 13 years try to find if being socially responsible improves employee productivity. They also analyse whether or not, all stakeholders including the shareholders are benefitted by CSR activities.

They find that when companies are socially responsible, productivity of employees improves and sales per employee goes up. But the same cannot be said of financial parameters relating to shareholders, namely, Return on Investment (ROI), Return on Equity (ROE) and Return on Capital Employed (ROCE). These are observed to go down when companies are socially responsible. Based on these findings, they conclude that CSR initiatives refocus a company’s activities from maximisation of wealth of shareholders to maximisation of interests of all stakeholders.

To identify companies that are socially responsible, the researchers have considered those companies that have been included in Domini Social Index 400 (DSI 400). They have also considered in their study, those companies that are not included in the index. They also take into consideration
companies that have been dropped from the index to study changes after being excluded from the index.

5 Studies that have related findings

McGuire et al (1988) studied the relationship between (i) corporate social responsibility initiatives and a firm’s past financial performance i.e. financial performance before the firm embarked on CSR activities and (ii) CSR and post-CSR financial performance. A significant finding from their study is that firm risk reduces as a result of CSR activities.

For their study, they considered companies that were rated by Fortune Magazine’s annual survey of corporate reputation. They used two sets of rated companies, namely 131 companies rated in 1982 and 98 companies that appeared in all the yearly surveys. For measuring financial performance, they considered accounting based measures of ROA, total assets, sales growth, assets growth and operating income growth. They also considered market based measures of total return and risk-adjusted return. They find that ROA is a better measure of financial performance to study the effect of CSR than market based measures such as total return.

Servaes and Tamoyo (2013) study the impact of CSR activities on a firm’s financial performance. They study firms included in the KLD Stats database constructed by KLD Research and Analytics, Inc during the period 1991 to 2005. The number of firms considered for the study is around 400 between the period 1991 and 2000 and grows to around 2000 in the year 2005. The financial measure used for the analysis is Tobin’s Q. One of their findings is that those firms about whose products and services customer awareness is high, realise a positive impact on their financial performance from their CSR activities. And, for those firms customer awareness is low, there is no impact on financial performance from CSR activities. As to the reason for customer awareness resulting in a higher impact of CSR on financial performance, they attribute it to the goodwill that is created for the firms through the awareness. They also find that firms that do not enjoy a good reputation in the market do not reap the financial benefits of CSR.

5. Analysis

The outcome from the various studies that have been done over the past 40 years or so can be best summarised by the observations of Margolis et al (2009). These researchers did a meta analysis of 251 studies on the subject during the period 1972 to 2007. They express the view that if a positive link can be established between CSR activities by firms and financial performance of firms, then firms could be persuaded to engage in social activities and the long standing debate of whether or not firms should engage in CSR work can be laid to rest. They conclude that effect of CSR activities on financial performance of firms is small, positive and significant. CSR activities do not destroy shareholder value.

6. Conclusion

The current study involved analysing various researches done over a period of time to understand the impact of corporate social responsibility initiatives by firms on their financial performance. The major finding from this analysis is that the results of various research studies have yielded different results and the findings are mixed. Prior studies have reported positive, negative and neutral impact on financial performance. However, it appears that the predominant view is that CSR initiatives of a firm have a positive impact on its financial performance.
REFERENCES