

Corporate Social Responsibility and financial performance in the Sri Lankan context

P.M.C.Thilakerathne

Abstract

In today's globalized competitive business world, there is a growing interest in, and concern for Corporate Social Responsibility (CSR). There has been an emerging trend to believe that corporate social responsibility can contribute to the financial performance of a company. This approach, which has been described as the 'enlightened shareholder approach', suggests that corporate decision-makers must consider a range of social and environmental concerns if they are to maximize long-term financial returns of companies. There have been a number of studies based on developed country data that seek to test the extent to which the economic drivers for corporate social responsibility deliver improved financial performance. These studies adopt different methodologies for measuring corporate social responsibility and financial performance, and not unexpectedly present quite different results.

This study makes use of regression analysis to test the hypothesis that corporate social responsibility improves the financial performance of companies. Findings revealed that the relation between CSR and financial performance is much weaker than expected in case of Sri Lankan companies. Further, results suggest that strong stock market performance leads to greater firm investment in aspects of CSR devoted to employee relations, but that CSR activities do not affect financial performance. Research concludes that CSR is driven more by unobservable firm characteristics than by financial performance. However, in conducting the analysis a number of opportunities for refining the research were identified. As such, this paper could be considered as a first step towards in testing the relationship between financial performance and corporate social responsibility in the Sri Lankan context.

Introduction

Corporate Social Responsibility (CSR) is associated with the conduct of companies and in particular whether companies owe a duty to stakeholders other than shareholders. Whilst the phrase 'Corporate Social Responsibility' may be gaining momentum, the concept itself is not new (Clark 1982). The modern concept of CSR states that the business enterprises in their usual process of business decision making should pay due attention to the social interests of the people in the community (Sakar 2005). A company is not just an economic entity; it is a social and political entity also (Tarrant 1976). Business decisions taken by the managers are not only affecting to stockholders, but also the stakeholders. Therefore, companies must give due consideration to the interest of all the stakeholders. There is currently a debate on the extent to which company directors and managers should consider social and environmental factors in commercial decision making. An approach to decision making that routinely encompasses these factors may be described as corporate social responsibility.

A view is emerging that Corporate Social Responsibility (CSR) can contribute to the Corporate Financial Performance (CFP). This approach, which has been described as the 'enlightened shareholder approach', suggests that corporate decision-makers must consider a range of social and environmental matters if they are to maximize long-term financial returns. However, the effect of CSR on achieving CFP seems that as mere expectations. Despite the beliefs regarding a positive relationship between CSR and CFP, the results of empirical studies have been mixed. In addition to that, researchers (Benerjee, Iyer and Kahyap 2003, Henriques and Sadosky 1996, Lankoshi 2000) have found financial outcomes to vary across industries.

This paper presents some preliminary findings about the relationship between the adoption of Corporate Social Responsibility (CSR) and the Corporate Financial Performance (CFP) of Sri Lankan companies, and identifies opportunities for further quantitative research in this area.

Literature Review

Previous studies have reported mixed picture on the relationship between CSR and CFP. Some researchers have found a positive relationship, some negative, and others no relationship at all. The studies that have found positive effects used diverse measures of financial performance, including return on

equity (Bragdon and Marlin 1972; Moskowitz 1972); profitability, measured as net income, net income as a percentage of sales, net income as a percentage of stockholders' equity, and earnings per share (Parket and Eilbirt 1975); return on assets (Rodriguez and Cruz 2007; Tsoutsoura 2004); and return on sales (Tsoutsoura 2004). On the other hand, other studies found negative effects of CSR on financial performance, measured as stock prices (e.g., MacKinlay 1997; Vance 1975; Wright and Ferris 1997), or no relationship between the two (e.g., Abbott and Monsen 1979; Alexander and Buchholz 1978; Carroll 1999; McWilliams and Siegel 2000; Ullmann 1985).

These various results may be a function of differing definitions of CSR or financial performance and of various analysis methods. Moreover, most studies have presumed a linear relationship between the two, although impacts of CSR may vary according to the degree of a company's investment in CSR. In contrast to the linear assumption, Bowman and Haire (1975) found a U-shaped relationship between CSR and financial performance, but their simple graphical explanation lacks a statistical inference. Another factor is the time line of the research. Some researchers (e.g., Epstein and Roy 2007; Tsoutsoura 2004) have suggested that the costs of an initial investment in CSR may exceed the benefits companies can realize in a short time period. Besides various arguments over the nature of the relationship, there are two different theories regarding the direction of the relationship between CSR and financial performance. While the available funds or slack resources theory (Waddock and Graves 1997) states that higher financial performance in time 1 leads to a higher level of CSR activities in time 2, the managerial opportunism theory (Preston and O'Bannon 1997) suggests that higher financial performance leads to a lower level of CSR activities. This research attempts test those notions to a certain extent.

Measuring Corporate Social Responsibility

An initial challenge in testing the relationship between corporate social responsibility and financial performance is identifying those companies that have adopted corporate social responsibility. This is because corporate social responsibility reflects an approach to internal decision making, the presence or absence of which may not easily be determined by external observers.

The approach that was adopted for this paper was CSR measurement (Abbot and Monsen 1979, Brown 2001, Rashid and Ibrahim 2002, Kapoor and Sandhu 2010) covering an inventory of 37 items covering major seven dimensions, namely, involvement in community projects including education,

Employment opportunities & employee welfare, Caring for the Environment, Quality of goods & services produce, customer relationships, Shareholder relations, rural development and diversity. After identifying CSR activities the technique of content analysis of the annual reports of companies and their individual websites is used to measure CSR in terms of CSR scores. The scoring procedure applied in this study is Ernst and Ernst (1978) and Abbot and Monsen (1979). Under this approach all the CSR related activities are given equal weightage. Thus, the number of items adopted by each company has been computed by adding score of each item as disclosed by it in the company annual report and the website. CSR activities have been measured of companies by applying following formula;

CSR score of a company = (Number of CSR items adopted by a company/ Total number of items in the CSR measurement instrument) *100

Data and Methodology

To examine whether or not companies listed in the Colombo Stock Exchange (CSE) financially benefit from their CSR activities, researcher conducted a study based on a regression model which has been used in previous studies on the topic. Picking up on Bowman and Haire's (1975) indication of a U-shaped relationship, this study expands the previous models by including a curvilinear function of CSR, an approach not used in many existing studies.

$$TSR(ROE)_{it} = \alpha_1 CSR + \alpha_2 CSR^2 + \alpha_3 SIZE + \alpha_4 LEVERAGE + \alpha_5 YEAR Dummies_{1-13} + \alpha$$

One of the two dependent variables of financial performance indicators, total shareholder return (TSR) represents total returns to shareholders and it is used in this study to reflect a company's value performance.

The estimation of TSR (Bloom and Miklovich 1998) is as follows: (Ending Share Price – Beginning Share Price + Dividends)/Beginning Share Price. The other dependent variable, return on equity (ROE), represents a company's accounting performance and is estimated by dividing net income by total stockholders' equity. The main independent variable of the study is CSR, and two variables (CSR and CSR²) are included in the model to examine the possibility of a curvilinear relationship between CSR and TSR (ROE), where CSR denotes impacts of CSR activities at stage 1 and CSR² denotes effects at stage 2. CSR² is estimated by squaring the difference between the mean value of CSR and any individual value of CSR, in a process called centering, to reduce multicollinearity (Tabachnick and Fidell 2001).

The three control variables are (1) size, which is company size, estimated by the log of total assets; (2) leverage, which is capital structure of the company, estimated by debt-to-asset ratio; and (3) year dummies to control for any effects from a particular year's events (e.g., ending of the 30 year civil war, economic conditions). μ represents a random error term.

As widely used by previous researchers examining CSR effects on financial performance in recent years (e.g., Hillman and Keim 2001; McWilliams and Siegel 2000; Waddock and Graves 1997), the data for this study are from the annual assessment of thirty companies listed in the Colombo Stock Exchange (1996-2008) have been used. The study examines a total of 116 company year observations of CSR activities (CSR scores) in thirty companies selected on the basis market capitalization.

Analysis and interpretation

As Table 1 shows, the average CSR for the selected companies is 0.448 ($SD = 5.641$), ranging from -17 to 16. The mean value of 0.448 indicates that sample companies do not on average participate much in CSR activities. Total shareholder return shows a mean value of 0.186 ($SD = 0.456$) with a maximum TSR of 1.756 and a minimum of -0.824. Similarly, return on equity varies widely, from -0.680 to 0.992 with a mean of 0.146 ($SD = .184$). The average for total assets is Rs. 382.3 million, and the leverage ratio is 0.47.

Table 1

Descriptive statistics

Variable	N	Mean	Minimum	Maximum	Standard Deviation
CSR	116	0.448	-17	16	5.641
TSR	116	0.186	-0.824	1.756	0.456
ROE	116	0.146	-0.680	0.992	0.184
TA (in millions)	116	Rs 382.3	Rs. 38.0	Rs. 979.6	Rs.680
Leverage ratio	116	0.470	0.188	0.890	0.149

Note: CSR = corporate social responsibility; TSR = total shareholders' return, estimated as follows: (Beginning Stock Price - Ending Stock Price + Dividends per Share)/Beginning Stock Price; ROE = return on equity, estimated by dividing netincome by total stockholders' equity; TA = total assets in millions of LKR; Leverage is a ratio to represent a firm's capital structure, estimated by debt-to-asset ratio

According to the correlation test results (Table 2), CSR positively correlates with size ($r = .464$) and negatively correlates with leverage ($r = -.234$). ROE has no statistically significant correlation with CSR, but it has a significant and positive correlation with TSR ($r = .346$) and size ($r = .481$). Size has a positive correlation with CSR ($r = .464$) and negatively correlate with leverage ($r = -.234$). ROE has no statistical correlation with CSR but it has a positive correlation with TSR ($r = .346$) and size ($r = 0.481$). No multicollinearity discernible among the independent variables selected for the study.

Finally, researcher conducted a pooled regression analysis, controlling for firm size, capital structure (leverage), and year effect (year dummies), which may influence the relationship between CSR and financial performance. Results show that CSR (t -value = 0.487) and CSR² (t -value = -0.649) do not appear to affect value performance (TSR), whereas only size negatively influences total return (t -value = -2.114). Leverage does not significantly influence value performance (t -value = 1.675). CSR (t -value = -2.256) negatively influences accounting performance (ROE), while CSR² has a positive effect (t -value = 2.246), suggesting the existence of the earlier-mentioned U-shaped relationship. The effect of size is positive on accounting performance (t -value = 4.745), unlike its effect on value performance, which is negative. Leverage is found to have no significant effect on accounting performance as on value performance (Table 3).

Table 2

Variable	TSR	ROE	Size	Leverage
CSR	0.-081	0.-091	0.464**	0.-234*
TSR		0.346**	0.-185*	0.053
ROE			0.481**	0.276*
Size				0.355**
Leverage				

Note: CSR = corporate social responsibility; TSR = total shareholders' return, estimated as follow: (Beginning Stock Price - Ending Stock Price + Dividends per Share)/Beginning Stock Price; ROE = return on equity, estimated by dividing net income by total stockholders' equity; TA = total assets in millions of LKR; Size represents firm size, estimated by log of total assets; Leverage is a ratio to represent a firm's capital structure, estimated by debt-to-asset ratio. **Significant at .01 and * Significant at .01

Table 3
Summary of pooled Regression Analysis

	Coefficient	t-value	p-value	VIF
TSR = $\alpha_0 + \alpha_1\text{CSR} + \alpha_2\text{CSR}^2 + \alpha_3\text{SIZE} + \alpha_4\text{LEVERAGE} + \alpha_5\text{-19YEAR Dummies1-15}$				
CSR	0.045	0.487	0.691	1.873
CSR ²	-0.059	-0.649	0.526	1.247
Size	-0.232	-3.114*	0.038	1.765
Leverage	0.156	1.675	0.116	1.403
----- F-value = 2.271** Ad. R ² = .167				
ROE = $\beta_0 + \beta_1\text{CSR} + \beta_2\text{CSR}^2 + \beta_3\text{SIZE} + \beta_4\text{LEVERAGE} + \beta_5\text{-19YEAR Dummies1-15}$				
CSR	-0.243	-2.256*	0.034	1.885
CSR ²	0.190	2.246*	0.045	1.301
Size	0.400	4.745***	0.001	1.791
Leverage	0.045	0.462	0.645	1.425
----- F-value = 2.433** Ad. R ² = .185				

Note: CSR = corporate social responsibility, estimated by the CSR ratio; CSR² represents a quadratic form of CSR; TSR = total shareholders' return, estimated as follow: (Beginning Stock Price – Ending Stock Price + Dividends per Share)/Beginning Stock Price; ROE = return on equity, estimated by dividing net income by total stockholders' equity; Size represents a firm's size, estimated by log of total assets; Leverage represents a firm's capital structure, estimated by debt-to-asset ratio; VIF= Variance Inflation Factor; Year Dummies represent dummy variables, controlling for year effects from year 1996 to 2008 where the base year is 1995. Results of fifteen Year Dummies are not presented in the table because of limited space and their secondary importance to the study as control variables. *Significant at .05. **Significant at .01. ***Significant at <.001.

As discussed earlier, a sample company's financial performance in one year may influence the level of CSR activities in the following year. That is the thesis of the available funds or slack resources theory. On the other hand, managers may see a good financial year as an opportunity to increase their bonuses by cutting expenses, including their investment in CSR activities. That is the basis of the managerial opportunism theory.

To test whether better financial performance leads to a higher level of CSR or to a lower level of CSR, we regressed CSR in the year head of independent variables (leadCSR) on TSR, ROE, and the three control variables (size, leverage, year dummies). Results show that a higher ROE (accounting performance; t -value = -2.916) leads to a negative CSR, which supports the managerial opportunism theory (Preston and O'Bannon 1997); whereas TSR (value performance; t -value = 1.897) has no effect on leadCSR. Size has a positive effect on lead CSR in both models, while leverage appears to negatively correlate to leadCSR in both cases (table 4).

Table 4

Regression analysis with leadCSR as dependent variable

	Coefficient	t-value	p-value	VIF
leadCSR = $\beta_0 + \beta_1$ TSR + β_2 SIZE + β_3 LEVERAGE + β_4 -18YEAR Dummies1-13				
TSR	0.179	1.897	0.149	1.515
Size	-0.398	2.966*	0.006	1.609
Leverage	0.459	- 3.958***	0.001	1.293
----- F-value = 2.271** Ad. R ² = .167				
leadCSR = $\alpha_0 + \alpha_1$ ROE + α_2 SIZE + α_3 LEVERAGE + α_4 -18YEAR Dummies1-13				
CSR	-0.443	-2.916*	0.005	1.308
Size	0.564	3.876**	0.002	1.552
Leverage	0.039	-3.497**	0.003	1.426
----- F-value = 2.433** Ad. R ² = .185				

Note: CSR = corporate social responsibility; CSR2 represents a quadratic form of CSR; TSR = total shareholders' return, estimated as follow: (Beginning Stock Price – Ending Stock Price + Dividends per Share)/ Beginning Stock Price; ROE = return on equity, estimated by dividing net income by total stockholders' equity; Size represents a firm's size, estimated by log of total assets; Leverage represents a firm's capital structure, estimated by debt-to-asset ratio; VIF = Variance Inflation Factor; Year Dummies represent dummy variables, controlling for year effects from year 1996 to 2008 where the base year is 1995. Results of fifteen Year Dummies are not presented in the table because of limited space and their secondary importance to the study as control variables.

Significant at .01. *Significant at <.001.

Concluding remarks

Results of this study indicate that the market essentially failed to reward the thirty companies studied with a higher value in consideration of their corporate social responsibility activities. However, we found that in the long term, the firms studied did show an improved return on equity for their efforts. Moreover, data based on thirty companies indicated that existing rules and policies encourage managers to build their bonuses in good years, rather than use the cash flow from strong profits to expand CSR activities, a phenomenon known as managerial opportunism. Firms in this study varied widely in terms of their CSR spending. Despite these results, researcher is interested to raise an issue that may not be directly captured in our financial data. Based on the study results, conclude that restaurant companies' investment in CSR may not be perceived as a value-added activity by the financial markets. Researcher believe that a major reason the market might not have fully realized the value of the CSR investment is that companies' communication with the customer and the financial market regarding their CSR investment has yet to be sufficient or effective.

As per the other financial performance measure, accounting performance, results show that the effect of CSR decreases accounting performance of sample companies at a lower degree of CSR investment at the first stage, but it becomes positive as the level of CSR investment increases at the second stage, confirming the curvilinear (i.e., U-shaped) relationship hinted at in earlier research. This finding suggests that the cost of CSR activities is initially greater than the benefits the company can obtain in terms of accounting numbers. However, over time the investment seems to pay off, perhaps because it takes time for customers, employees, governments, and the public to recognize and appreciate the company's CSR activities.

Findings of this research i.e. managerial opportunism can be considered as tentative due to a tiny *N*. Our study indicated that the theory holds for the restaurant industry's accounting performance but not for its value performance. This could happen because managers' compensation is usually based on accounting numbers, not company value. However, we urge careful interpretation of these results because of the small sample size. Therefore, future studies should examine this issue with a larger sample than that of this study. This study results give no definitive answer to the question of whether the market financially rewards companies for socially responsible activities. Despite the mixed findings for value and accounting performances measures, we are convinced that consistent and sincere "good deeds" by companies, along with a better communication about CSR activities, should eventually help the market recognize the value of the firm's investment in social responsibility and, thus, reward companies for such investment. These good deeds, "even if successful, may not help managers make their numbers next quarter" but may help the market sort out "long-term survivors from the dinosaurs" (Engardio 2007, 64). Therefore, companies' continuous efforts to be good citizens via strategic CSR activities, which can contribute to the society's well-being, might well be necessary for sustainable success.

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