Corporate Social Responsibility and Firms' Financial Performance: A Conceptual Framework

Amin Ullah Khan[1], Haseeb Ur Rahman[2], Zafir Ullah Khan[3], Zubair[4]

Student MS Management Science at IMS, University of Science &Technology Bannu, KP, Pakistan[1].
Assistant Professor, Institute of Management Science, University of Science &Technology Bannu, KP, Pakistan[2].
Assistant Professor and HOD Economics Department, University of Science &Technology Bannu, KP, Pakistan[3].
Assistant Professor, Institute of Management Science, University of Science &Technology Bannu, KP, Pakistan[4].

Abstract

This paper conceptually analyses the impact of corporate social responsibility (CSR) on firms' financial performance. CSR is considered as an important business strategy that achieves a steady growth in firms' profitability through improving their image. It includes all those strategies which account for are an ethical conduct and society friendly approach beneficial for the development of society. In addition to profit-maximization, the firm is also supposed to undertake activities which uplift the life of employees and the general public. In this regard, the conceptual framework of the current study shows that firms spend on awarding scholarships to needy students, health activities such as health awareness program, free medical camps, environmental protection awareness programs and sports activities. The conceptual framework also highlights that firms with large capital spend more on CSR activities owing to an increased pressure of the government, public, media and other stakeholders. Based on the previous extant literature, it is also assumed that firms which earn higher profits spend more on CSR in the coming year/s that have positive impacts on their profitability. However, by following theoretical postulations, it is assumed the relationship between CSR and firms' profitability may be endogenous. Accordingly, this study proposes dynamic GMM estimation that is a preferred technique, particularly in the presence of endogeneity.

1. INTRODUCTION

Corporate social responsibility (CSR) is considered as an important business strategy to achieve steady growth in business profit through improving their mage of the firm. It is a mechanism according to which organizations work for the wellbeing of society and achieve lasting values for shareholders. CSR refers to those strategies which are ethical, environmentally friendly and beneficial for society. Firms or corporations in addition to profit-oriented activities, also undertake activities which uplift the life of employees and the general public. Sustainable corporate social responsibility (SCSR) refers to those social activities which meet the needs and aspirations of the present generation without compromising the ability of future generations to meet their social, environmental and economic needs (World Commision on Environment and Development, 1987). CSR activities enhance commitment level of existing customers and attract new customers that increase firms' profitability through increasing sales (Stanwick & Stanwick, 1998; Maignan & Ferrell, 2003).

Carroll theoretical Framework of CSR consists of economic, legal and ethical dimensions of organizational activities (Schwartz & Carroll, 2003). According to him, organization primary objective is the maximization of profit while compliance with legal obligations and ethical practices are secondary motives for organizations. Because, most of the countries around the world, the law. However, in today's' competitive age, organizations themselves undertake such activities to improve the welfare of stakeholders and improve their image in the society (McWilliams & Siegel, 2001). Despite the acceptance of CSR by the corporate sector, still, many researchers, regulators and other key stakeholders have doubts about its legitimacy, effectiveness and above all economic justification in today's competitive business environment. In this connection, some scholars even suggested a negative relationship between CSR and firms' profitability. They view that expenditure on CSR actually increases the cost of the firms that ultimately reduce their profits (McGuire, Sundgren, & Schneeweis, 1988).

According to Milton Friedman, managers are the agents of principals and if they spend more on CSR, they are actually utilizing somebody else money which affects their profitability. Besides affecting investors, it is also argued that CSR reduces wages to employees and increase cost for customers (Friedman, 1970). He is of the view that companies should select those CSR activities which will provide long-term benefits like donations to charitable organizations or spending on community welfare. He added that these will help to save taxes on one hand and creating a competitive advantage in the industry on the other hand. Other support Friedman (1970) stance that businesses should indulge in strategic CSR which will help them to enhance their goodwill and optimize their profits (Husted & Salazar, 2006). But a survey shows that majority of customers prefer to buy products of socially responsible firms and also about 76% of the customers are willing to switch from the firms which do not practice CSR activities to those which are active in this regard (Maignan, Ferrell, & Hult, 1999). In another survey of 1000 customers in the USA, 43% customers were found very impressed by firms which actually donated for welfare and development of the society (Hess, Rogovsky, & Dunfee, 2002).

Previous studies on the relationship between CSR and organizational profitability are not conclusive. Lee (2008) suggested that keeping abreast of global trends and remaining committed to financial obligations to deliver both private and public benefits have forced firms to reshape their frameworks, rules and business models, among others. Also, it is argued that companies which do not take into account CSR may not survive since they may fail to innovate (McGuire, Sundgren, & Schneeeweis, 1998). They conjectured that a mechanism may be developed on the basis of constructing a link between innovation and CSR. Others found that firms' financial performance is greatly influenced by CSR activities they carried out (Sandra & Graves, 1997). Seifert et al, (2003) found a weak but positive correlation between available cash and firms' CSR activities. Some also documented that CSR activities of the firm positively impact employees' satisfaction which in turn increases their profitability through enhancing productivity (Hossein, Kamran, Mostafa, & Hossein Ali, 2012).

The cited studies indicate that organizations initiate CSR activities mainly to increase their profitability through improving their image in societies. However, in today's' competitive world, organizations are required by law to contribute to the development of society at large. As the general public is the ultimate target of firms' activities which has externalities, therefore, with the pace of growth of the industry, their impacts are expected to have significant impacts on firms' performance. As the banking sector is comparatively good or active in performing social activities than other industries, therefore, it would be better to empirically analyze the impact of CSR activities on the profitability of banking industry of Pakistan. In addition, unlike most of the previous studies, the present study aimed to investigate the business case of CSR.

2. RESEARCH GAP AND EXPECTED CONTRIBUTION OF THE STUDY

All the previous studies, both theoretical and empirical, cited above and all others to the best of my knowledge have considered only the impact of current CSR activities on firms' profitability but ignore the relation of lag CSR activities with lag profitability. Also, previous studies have not examined whether there is any relationship between current CSR and lag CSR. Besides these, the present study also proposes to examine the relation of economic growth stage with firms' CSR activities and its indirect effect on firms' profitability.

Studies on the relationship between CSR and firms' performance produced contradictory results. Some have a viewpoint that firms incur less explicit cost on CSR activities while they greatly benefited in return as these activities improve employees' morale and productivity (Moskowitz, 1972; Parket & Eibert, 1975). Others view that explicit cost of CSR activities are significant, but these are offset by a reduction in other costs. That is CSR activities improve the image of the firm and its management that facilitate the exchange of costly explicit claims for less costly implicit claims (Cornell & Shapiro, 1987). Based on this, the current study proposes to examine whether CSR has any impact on firms' profitability or not. Also, the study suggests whether firms' prior financial performance predicate their current CSR activities or not. In view of these, the proposed study contributes to existing literature by examining the stakeholder theory or classical theory of firm by introducing an interaction term between lag CSR and current profitability of banks in the conceptual framework. Moreover, the conceptual framework by passing empirical test would also determine whether CSR activities are sustainable in banking industry Of Pakistan. Also, the proposed study contributes in that to use the effect of past CSR activities on firms' current financial performance in the banking industry of Pakistan as this has overlooked by the prior extant literature in the area.

3. CONCEPTUAL FRAMEWORK OF THE STUDY

Firms' objective is to maximize profit subject to resource constraint and regulations imposed by the government of the country. As firms are directly dependent on society for resources such as labour, capital, raw material, and land, therefore they try to maximize their objectives subject to economic and social cost. To compensate the society for the social cost imposed by the operation of the firms, they often engage in philanthropic activities such as the provision of scholarship to poor students of society, medicine to poor families free of cost, the arrangement of health awareness programs, awareness programs regarding control of pollutions etc. These activities not only meet their regulatory obligations but also create goodwill that improves their financial performance, particularly in the long-run.

This study analyses the impact of CSR activities on the financial performance of banks. As banking sector is the most competitive sector in Pakistan and having a long-recorded history of social activities, it would provide better empirical insight regarding the impact of social activities on their profitability. The proposed study focuses on banks for their CSR and its impact on their profitability. Figure 1.1 shows that banks help society by engaging in CSR activities i.e. providing a donation contribute to education, health, and environment. As these activities increase goodwill of the bank in society, therefore, the expected profit is supposed to be increased through increase in customers.

Figure 1.1 shows that companies with large size are expected to spend more on social activities because large firms have a wider range of stakeholder as well as government constantly monitor their social activities (Hackston & Milne, 1996). As with increase in the size of the firm and by virtue of their financial resources and economies of scale, it would be easy for the firms to undertake social activities as compared to small firms (Brammer & Millington, 2008).

In the banking industry, size of a bank is used to highlight economics and diseconomies of scale. As the scale of bank increases, its turnover also increases. It is shown in the figure 1.1 that size of the bank can both directly (Gul, Irshad, & Zaman, 2011; Pervan, Pelivan, & Arneric, 2015) and indirectly effects banks' profitability. It is also conjectured that banks with larger size would be able to spend more on social activities. The figure 1.1 shows that size of the bank also leads to CSR activities expanding the size of the market for the bank and thereby profitability of the bank.

Past financial performance (here measure with lag profitability) is expected to affect banks' profitability. Banks with a substantial past profit are expected to provide diverse banking facilities to customers which may increase their profitability. It also can indirectly increase the profitability i.e. banks with initial financial strength would be able to finance social activities which in turn increase their profitability. This implies that initial financial position is a stimulus for firms' subsequent profitability (Surroca, Tribó, & Waddock, 2010).

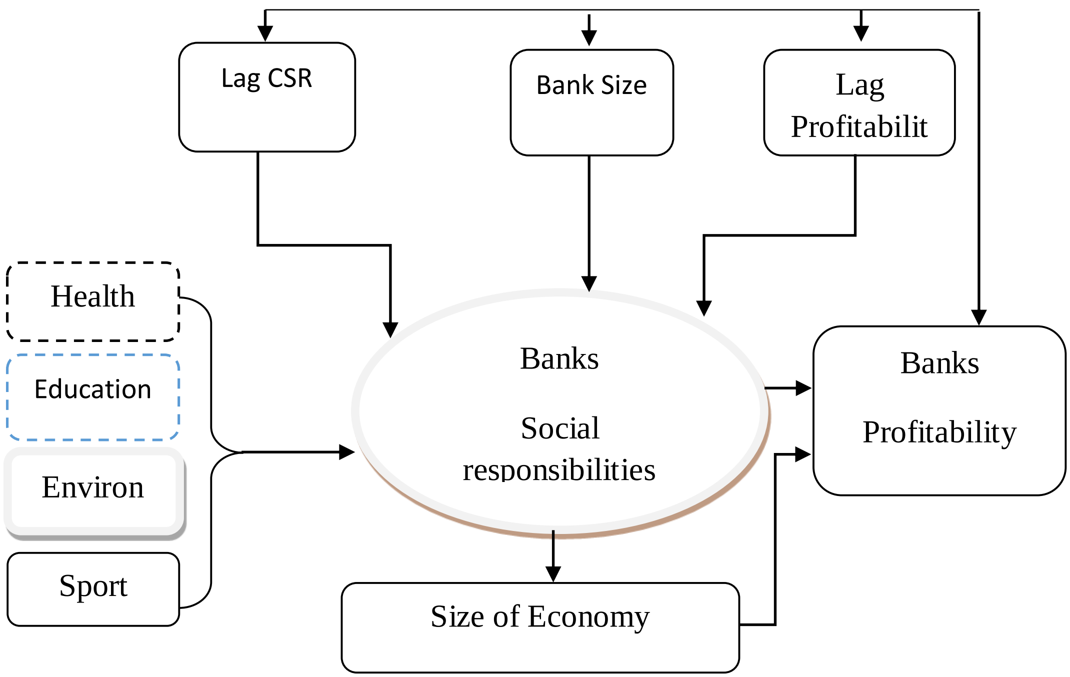

Figure 1.1: Conceptual Framework

It is shown in the figure that banks which earned more profit in previous years are expected to spend more on social activities in expectation to increase its profit through improving firm's image (McGuire, Sundgren, & Schneeeweis, 1998). As against to Classical Economist, Milton Friedman (1991), explicit cost of CSR activities are significant but offset by a reduction in other costs due to CSR activities. That is CSR activities improve the image of the firm management and so it can exchange costly explicit claims for less costly implicit claims (Cornell & Shapiro, 1987) and thus would result in improvement of firm performance.

Figure 1.1 also indicates that firms with a higher track record of social activities would also undertake more social activities at present to maintain its image in society (Hammond & Jr, 1996). It is also the hypothesis that countries with greater social activities would enjoy high per capita economic growth. The private sector always focuses on increasing profit at the cost of society. Therefore, by initiating social activities would mean internalization of their external cost, thereby increasing the welfare of the economy. According to the finding of world value survey, an average 40 percent of the respondents from 65 countries are willing to pay more taxes, accept cut in income and pay a higher price to a product which is helpful in environmental degradation (Israel & Levinson, 2004). These studies indicate that countries with higher CSR activities also experience higher economic growth.

Figure 1.1 shows that countries with greater social activities would enjoy high economic growth and hence banks would enjoy the higher profit. Figure1.1 also shows that countries with high economic growth would also experience increasing social activities and therefore high profitability. Literature also indicates that organizations of developed countries spend more on social activities as compared to the organization in developed countries.

4. RESEARCH DESIGN

The current study uses a panel of ten banks and collects data on the variables of interest form the Annual reports of the banks from 2006-2016. The banks are selected because of the availability of data on CSR and profitability variables. Based on the conceptual framework of the paper, lag profitability is shown to impact the current performance of the firm (as found by (Surroca, Tribó, & Waddock, 2010) which suggest dynamic panel GMM model. Moreover, this paper also considers the specific effect of particular bank i.e whether the impact of CSR varied across banks. Based on the conceptual framework, we use the following dynamic panel GMM model given below.

$$Profitablity_{it} = Profitability_{it-1} + CSR_{it} + CSR_{it-1} * profitability_{it} + CSR_{it} * CSR_{it-1} + BankSize_{it} + BankSize_{it-1} * CSR_{it} + \emptyset X_{it} + \eta_i + \nu_{it}$$

Where "i" refers to the bank while "t" to time. $profitabilty_{it}$ is used to measure the financial performance of "ith" bank in period "t". η_i is used to measure bank-specific fixed effects and υ_{it} is the error term. X_{it} denotes control variable such as Research and development expenditure, advertising expenditure and age of the firm.

To measure the impact of current CSR on the financial performance of the bank, the current financial perspective of the bank is likely to be affected by both observable and unobservable heterogeneity which also determine CSR activities. Also, the conceptual framework indicates that there is simultaneity problem in the model i.e. CSR also dependent on firm financial position. One solution is to estimate the effect of CSR on firm performance financial performance using System of equations and would require a strict exogenous instrument. Dynamic system GMM can solve the problem as it uses internal instruments i.e. it uses a lag of explanatory variables as instruments (Arellano & S, 1991).

5. VARIABLES AND DATA

To estimate the model, we use the following variables.

5.1 Measures of Financial Performance

Most studies used accounting measures instead of market-based measures for gauging firms' financial performance (Waddock & Graves, 1997; Simpson & Kohers, 2002) like Return on Assets (ROA), Return on Sale (ROS) and Return on Equity (ROE). This paper also proposes ROA as financial performance following (John & John, 2010). This measure is preferred to all other measures because it takes into account assets for generating business profits. It shows whether a firm earns sufficient returns through utilization of their assets or not. According to Milton Friedman (1991), CSR activities are expenses of the firms which reduce the profits or returns of the shareholders. This paper uses ROA to examine whether social activities of the firms have any negative impacts on shareholder profits as discussed by Milton Friedman (1991).

5.2 Measures of Corporate Social Responsibilities

One of the issues of investigating the impact of CSR on the performance of the bank is the measurement problem because there is no single, ready or direct measure for corporate social activities. Prior studies used different variables to measure firms' CSR activities such as self-constructed surveys (Aupperle, Carroll, & Hatfield, 1985), the reputation survey (Brown & Perry, 1994) and KLD index, among others (Hull & Rothenberg, 2008). These indexes include both internal and external factors of CSR. The concept of CSR is newer particularly in developing countries like Pakistan. Hence, data on the indexes mentioned above is not available in Pakistan. Therefore, this paper proposes to use the expenditure of banks on education, environment, health, and sport as proxies of CSR activities which are reported in the income statement of each bank.

5.3 Firms' size and CSR

Large firms are expected to undertake more CSR activities as they draw more attention from public, media, and government. Moreover, firms' size also affects their strategic motivation, therefore, it is expected that firm size has a significant positive impact on CSR activities (Adams & Hardwick, 1998). As larger firms are likely to have a greater impact on the environment, so it would be justifiable for them to undertake more CSR activities for compensating the public and society (Cowen, Ferreri, & Parker, 1987). It is also found that large firms are more dependent on society for resources (inputs of productions), therefore, they spend more on social activities to uplift the standard of living of the stakeholders (Johnson & Greening, 1999). On the other hand, it is also found that small and medium-sized firms are comparatively less motivated than large firms to undertake CSR activities (Udayasankar, 2008). Accordingly, this paper uses the number of employees as a proxy of firms' size to examine its effects on their profitability. The paper proposes to examine whether firms with large size also spend more on the wellbeing of stakeholders which is considered a booster for the firms' profitability in the context of Pakistani banking industry.

5.4 Firms' Prior Performance and CSR

Most of the studies have examined the impact of CSR on firms' financial performance ignoring the future aspect while it is stated that the benefits of CSR activities are expected in the subsequent period/s. McGuire, Sundgren, & Schneeeweis, (1998) found a positive relationship between firms' past financial performance and its impact on subsequent CRS activities (whose prime objective is to improve firms' image). This paper also suggests examining the indirect effect of firms' previous financial performance on the current financial performance through its impact on CSR in the context of the banking industry in Pakistan.

6. CONCLUSION AND WAY FORWARD

There are a number of studies on the relationship between CSR and firms' performance. However, these studies have overlooked the missing link i.e. the effect of past CSR on the firms' current financial position. Also, these studies ignored the effect of firms' past financial performance on present CSR activities and current financial position. Therefore, this study proposes a conceptual framework to analyse the links between CSR activities and financial performance of banks in Pakistan. This study also establishes a relationship between lag CSR and profitability of banks. As clear from the conceptual framework that those firms which spend more on CSR activities would attract the attention of stakeholders by improving their image that leads to an increase in sales. Also, the study assumes that banks with higher lag profit will spend more on social activities and hence will reap higher profits. The conceptual framework also highlights that firms try to maintain and further improve their image among public and employees; therefore, they are willing to spend more on CSR activities. This implies that firms CSR activities seem to be sustainable in the long run. This paper also proposes to estimate the conceptual framework empirically for the relationship between corporate social responsibility and firms' performance in developing countries like Pakistan.

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