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Exploring the interaction between Financial Performance and Corporate Social Responsibility in Pakistani Firms

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ABSTRACT

The concept of Corporate Social Responsibility (CSR) is as old as the business organizations. Business is considered to be one of the most important agents of changes within society for the last two centuries. CSR is a source of realizing the organizations about their obligations and responsibilities towards the society where they perform their business activities. However, in order to perform CSR activities Financial Performance (FP) plays a critical role. As firms with better financial performance are in the better condition to provide the necessary funds and make investments for their social domains. In return these social activities not only help the firms in improving their profitability but also enhance their social value and reputation in the market as well. Therefore, both CSR and FP are interlinked with each other. Present study focused to find out the type of interaction that exists between CSR and FP in case of Pakistan. A panel data set of 100 non-financial firms for the period of 2006-2009 has been collected. Hausman test is applied on panel data in order to identify the fixed and random effect. Results of Generalized Least Square Random Effect Regression revealed the positive interaction between CSR and FP.

KEYWORDS: (Corporate Social Responsibility, society, Financial Performance, shareholders' value, Pakistan, Hausman test)

INTRODUCTION

In the modern financial research stream CSR "corporate social responsibility" is one of the extensively addressed issues. Questions regarding corporate social responsibility (CSR) attained great attention by academicians and managers during last few decades. CSR defined as the continuous commitment by business to behave ethically and contribute to economic development while improving the quality of life of their workforce and their families as well as the local community and society at large. It is a firm's long term goal about society which realizes the businesses that earning money is not the sole purpose of the business. Therefore, organizations must look forward beyond their economic activities in order to achieve sustainable development and established good relations with all related stakeholders. In the 21st century, world great companies confront number of new changes and challenges that will decide the survival and prosperity of these firms. After the world top companies scandals such as Nike, Enron, WorldCom and Parmalat along with the environmental changes due to the climate effect proved CSR as one of the most important challenges among the variety of new millennium challenges [1]. These issues not only forced the businesses to rethink their responsibilities towards their various stakeholders but also instigated the scholars to investigate the role of CSR in firm sustainable performance.

There is an increase in competition among the national and multinational companies to gain more advantages by establishing goodwill relationship between both the state and the civil society. Only those firms that attain the good will of the general public and behave good corporate citizens will be able to develop these intangible assets into strategic advantages in order to achieve organizational goals and objectives efficiently and effectively. In the 21st century, world great companies confront number of new changes and challenges that will decide the survival and prosperity of these firms. After the world top companies scandals such as Nike, Enron, WorldCom and Parmalat along with the environmental changes due to the climate effect proved CSR as one of the most important challenges among the variety of new millennium challenges [1]. These issues not only forced the businesses to rethink their responsibilities towards their various stakeholders but also instigated the scholars to investigate the role of CSR in firm sustainable performance and what type of relationship exist between CSR and firm's financial performance. Numbers of researchers all around the world have tried to find out the interaction between CSR and FP but conflicting results were found [2, 3]and this enhances the curiosity of researchers to further investigate this interaction. One of the main point of this debate is the nature of relationship

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between CSR and FP, so far researchers have proved the positive, negative, and no or neutral relationship between CSR and [4-6]. Major reasons for these limitations and conflicting results are lack of theoretical foundation and methodological problems [7].

Some of the researchers found Corporate Social Responsibility as financial burden for the firm and have negative impact on firm's performance [8]. When we are talking about negative interaction between CSR and CFP then we cannot conclude it without discussing the Friedman [9] work in this regard who started this debate and declared the negative relationship between corporate social performance and financial performance. According to the researchers who proved the negative association between CSR and financial performance of firms to generate funds and wealth for the stockholder is the major and core liability of the firm's management [5, 10]. While opponents of this view argued that firms have different classes of internal and external stakeholders and in order to satisfy their social demands and avoid their negative confrontations like boycotts, complaints, objections, and protests etc firms have to consider social commitments while taking their decisions [6, 11] . So the nature of association between CSR and financial outcomes is positive and CSR matters for the improvement of financial performance of corporations [12, 13]. Last class of researcher found no or neutral relationship between CSR and profitability of a firm [14-16]. The main reason of finding no relation between CSR and financial performance of firms are large numbers of confusing, complex and difficult factors that are important determinants to study the impact of CSR on profit[4, 17]. The nature of interaction between CSR and FP remained uncovered for the researchers and this might be the major cause that the researchers failed to conclude any particular correlation between CSR and financial performance and make this relationship complex as well difficult to understand [13].

Moreover, most of the above mentioned studies based on the CSR and FP interaction are conducted in the context of developed economies of the world. There are very few studies that provide the insight about this important issue. In addition to this, according to the best knowledge of author in the context of Pakistani firms there is hardly any study that investigates the interaction between CSR and FP. To fill this research gap and to develop the conceptualization of CSR in Pakistan, present study is aimed at exploring this issue of social concern and its relationship with firms' financial performance.

Significance of the study

Pakistan offers a context of typical developing country. The lack of infrastructure, low literacy rate, terrorism, energy crisis, non-availability of drinking water, corruption and fragile economic makeup are some of the issues being faced. Under these conditions the welfare role of government naturally shrinks. Through this study we can realize corporations that they can increase their supportive role to realize any of the development aspirations which in turn is beneficial for their prosperity and profit. Moreover, developing countries offer a unique business environment that is full of multiple challenges. CSR has the potential to contribute towards sustainable development of developing countries and solve complex challenges. At country level, present study helps in developing a corporate behavior where profitability is not considered as single working agenda. Business insiders need to reinvest their earnings towards the development of deprived segments of societies. These contributions can lead to better medical, educational, entrepreneurial and environmental programs, which will add to societal uplift.

LITERATURE REVIEW

In the finance literature we found a lot of studies that attempted to explore the nature of relationship between firm's profitability and its social performance [18]. Different researchers conducted different studies with different methodologies. Some adapted theoretical studies in order to prove that CSR has an impact on financial performance of a firm like [19] and on the other hand there is also the rich literature of empirical studies that had been done in order to find out the interaction between CSR and FP [20, 21]. In spite of all these studies, there is still lack of consensus among the results of different researchers on the nature of relationship between corporate social and corporate financial performance. The main reason is the certain theoretical and empirical limitations that make the relationship of corporate social performance and profitability complex and difficult to examine scientifically [22, 23]. On one stream of financial research, most of the researchers are in view that the interaction between CSR and FP is positive. As in the perspective of stakeholder theory Freeman (1984, pp. 25-26) argued that responsibility of the organization's management now goes beyond the profitability and they must consider the social affairs in their decisions because firm's responsibility is not only to satisfy the shareholders but to consider and satisfy all types of stakeholders. Stake holders like societal groups, consumers, suppliers, socially conscious share holders, regulatory authorities, Governments in recent times have emphasized and induced organizations be socially responsible and make investments in this regards.

Obtaing a sample of Standard &Poor 500 US firms. Ruf et al (2001) conducted a study to investigate that weather the change in CSR leads to change (decrease or increase) in the financial position of a firm. Regression findings provide some support for an ideology of the stakeholder theory which asserts that a firm can get financially benefit when management meets the demands of multiple stakeholders. Specifically change in corporate social performance was positively associated with growth in sales for the current and subsequent year. This indicates that there are short term benefits from improving CSR. On the other hand return on sales was significantly positively related to change in CSP for the third financial period, indicating that long term financial benefits also exist when CSR is improved.

Simpson and Kohers (2002) conducted an empirical study based on the USA banking industry and concluded the positive link between CSR and accounting based measures of financial performance of commercial banks. This research not only extended the earlier research work on the relationship between CSR and FP but also add contribution into it by empirically examining the banking industry and selecting the Community Reinvestment Act of 1997 as measure of corporate social performance. Two regression equations were tested separately, in the first equation ROA is regress over CSR and a set of control variables such as size, risk, local portfolio, funds cost and overhead expenses constant. In second equation loan losses again regress over CSR but with different set of control variables including bank size, size of the loan portfolio, risk of the loan portfolio, and economic conditions of the local loan market.

Another empirical study by Goll and Rasheed (2004) found the positive relationship between discretionary CSR and accounting performance with the moderating effect of firm's environmental munificence and dynamism. Size of the company taken as a control variable in this research measured as log of sales for 1985 and for accounting performance return on assets and retune on sales proxies used. CSR data is collected through a survey undertaken in 1985 and 1986 with a three-item scale in a sample of 62 firms using a questionnaire. Moderated regression analyses and subgroup analyses methods taken on to confirm the hypothesis that environment moderate the relationship between CSR and firm's accounting profitability. Results supported this hypothesis and found a significant and positive relationship between financial performance (ROA and ROS) with corporate social responsibility in highly munificent environment.

However, on the other stream of financial research; number of researchers also declared the negative interaction between CSR and FP. They found that Corporate Social Responsibility is a financial burden for the firms and have negative impact on firm's performance [8]. Friedman (1970) started this debate and declared the negative relationship between corporate social performance and financial performance. He argued that to generate funds and wealth for the stockholder is the major and core liability of the firm's management. Business management must represent the best interest of their shareholders while taking managerial decisions. Any other social and moral activities of a firm are totally unrelated to the firm's profit and interest of shareholders because these activities charges extra cost which ultimately reduces the profit margins for a firm and its shareholders. Therefore CSR is a source of conflict between that can lead the firm to severe disturbance in its financial performance as well as its relationship with shareholders. Business management must represent the best interest for the shareholders while taking managerial decisions and that interest must only be the maximizing profit for them; any other social and moral deliberations and intentions of a firm are totally unrelated to the firm's profit [24]. Moreover, decisions regarding these social activities can lead to severe conflict between management and their potential shareholders which further may cause the disturbances in the financial performance [5, 25, 26].

Hypothesis

There is a positive interaction between corporate social responsibility and financial performance as corporate social responsibility and its related matters are very critical and important for firms in order to achieve long term success and improve financial performance.

METHODOLOGY

Data and Sample

In order to investigate the relationship between CSR and FP in the context of Pakistan, present study initially selected 100 non-financial firms from the four manufacturing sectors (chemical, construction and material, automobile, pharma and bio-tech) listed at Karachi Stock Exchange. The panel estimation is done from the year 2006 to 2009. Only those firms selected in this study which remained listed during the period of 2006 to 2009 and disclosed the data of CSR in their financial reports. After meeting this criteria 62 firms finally selected and there are 248 observations. Manufacturing sector is one of the leading and third largest sectors in Pakistan which accounts for 18.5 percent of Gross Domestic Product (GDP), and 13 percent of total employment (Economic Survey of Pakistan 2009-10, pp. 39). The main reason for selecting manufacturing sector is the fact that it is involved in the production of goods, deals with machines and different types of hazardous materials which require more sensitive health and safety precautions for labor force and surrounding community, therefore it requires being more conscious about CSR [5].

Dependent Variable: Corporate Social Responsibility

Dependent variable of this study is Corporate Social Responsibility (CSR) which is defines as firm's responsibility to perform such activities that help them improving and promoting the societal well-being, protecting the environment and take good care of their employees and different stakeholders like societal groups, consumers, suppliers, shareholders, regulatory authorities and Governments beyond their legal and economical commitments [27, pp.3]. Thus, CSR is a multifaceted construct as different dimensions are used for its measurement. However, Present study used two dimensions Donations and Employee Welfare Fund for the measurement of CSR and used constructive measure of them as a proxy for CSR.

CSR = Donations + Worker's Welfare Fund/ Earnings before Tax

Independent Variable: Financial Performance

Four proxies Return on Assets (ROA), Return on Equity (ROE), Earnings Per Share (EPS) and Firm's Growth (FG) are used as a measure of financial performance. ROA represents return on assets which is calculated as ratio of earnings before tax to the total assets. ROE represents return on equity which is defined as earnings before tax divided by total number of common shares outstanding. EPS represents earnings per share; which is defined as net profit to number of shares outstanding [28, pp.156]. This study used growth in sales as a proxy for growth and is calculated as change (difference) in the annual sales value of firm with reference to its previous year's sales [(Salest – Salest-1)/Salest-1] [29, pp.149, 30, pp.150].

Other Control Variables

In previous research studies that investigate the relationship between CSR and FP suggested that leverage, size, risk and age are found to be the important factors that affect the social performance as well as financial performance of a firm, therefore (leverage, size, risk and age) are used as control variables in this study [31-33].

Where

Size is measured as LOTA = Log of Total Assets and LOTS = Log of Total Sales
Leverage is measured as LVRG = Long term debt/ Total assets
Age (AG) = Total Number of Years after Incorporation to date
Risk is measured as beta

Model specification

Following the studies of [34, 35] Random-effects Generalized Least Square (GLS) regression on panel data is used in this study to examine the given relationship between CSR and FP. As compared to Ordinary Least Square (OLS), GLS is capable of generating those estimators which are best linear unbiased estimators (BLUE) because it takes into account the variability in the dependant and independent variables explicitly [36, pp.395]. There are basically four models of this study; every model contains CSR as a dependant variable and financial performance as an independent variable with leverage, size, risk and age as control variables. There are four different measures of financial performance (ROA, ROE, EPS, and FG) and every model contains different proxy of financial performance.

When CSR is the dependant variable and ROA is independent variable

Model 1 $$CSR_{it} = \beta_0 + \beta_1 ROA_{it} + \beta_2 LVRG_{it} + \beta_3 LOTA_{it} + \beta_4 LOTS_{it} + \beta_5 RISK_{it} + \beta_6 AG_{it} + \varepsilon_{it}$$

When CSR is the dependant variable and ROE is independent variable

Model 2 $$CSR_{it} = \beta_0 + \beta_1 ROE_{it} + \beta_2 LVRG_{it} + \beta_3 LOTA_{it} + \beta_4 LOTS_{it} + \beta_5 RISK_{it} + \beta_6 AG_{it} + \varepsilon_{it}$$

When CSR is the dependant variable and EPS is independent variable

Model 3 $$CSR_{it} = \beta_0 + \beta_1 EPS_{it} + \beta_2 LVRG_{it} + \beta_3 LOTA_{it} + \beta_4 LOTS_{it} + \beta_5 RISK_{it} + \beta_6 AG_{it} + \varepsilon_{it}$$

When CSR is the dependant variable and FG is independent variable

Model 4 $$CSR_{it} = \beta_0 + \beta_1 FG_{it} + \beta_2 LVRG_{it} + \beta_3 LOTA_{it} + \beta_4 LOTS_{it} + \beta_5 RISK_{it} + \beta_6 AG_{it} + \varepsilon_{it}$$

Table 1: Regression results when financial proxy is ROA
Dependent Variable: Corporate Social Responsibility

Model-1					
Independent Variable	Control Variables				
ROA	Leverage	Size (Log of Total Assets)	Size (Log of Total Sales)	Risk	Age
3.52***	-2.55***	-0.47	-0.09	2.16*	1.19
(0.258)	(-0.136)	(-0.557)	(-0.633)	(0.748)	(0.066)
	Year Dummy	Yes			
	R^2	0.124			
	Wald-Chi Square	28.97***			
	$P(x^2)$	0.0001			
	Panel Data Model Type	Random			
	Hausman Test	3.47			
	Durbin Watson	1.98			

+p < 0.10; *p < 0.05; **p < 0.01; ***p < 0.001

Table 2: Regression results when financial proxy is ROE
Dependent Variable: Corporate Social Responsibility

Model-2					
Independent Variable	Control Variables				
ROE	Leverage	Size (Log of Total Assets)	Size (Log of Total Sales)	Risk	Age
3.47***	-2.61***	-0.55	-0.13	2.13*	1.31
[0.145]	(-0.139)	(-0.654)	(-0.231)	(0.741)	(0.073)
	Year Dummy	Yes			
	R^2	0.122			
	Wald-Chi Square	28.46***			
	$P(x^2)$	0.0001			
	Panel Data Model Type	Random			
	Hausman Test	4.04			
	Durbin Watson	1.94			

+p < 0.10; *p < 0.05; **p < 0.01; ***p < 0.001

Table 3: Regression results when financial proxy is EPS
Dependent Variable: Corporate Social Responsibility

Model-3					
Independent Variable	Control Variables				
EPS	Leverage	Size (Log of Total Assets)	Size (Log of Total Sales)	Risk	Age
2.66***	-2.81**	-1.06	-0.08	2.16*	1.30
(0.200)	(-0.150)	(-1.271)	(-0.063)	(0.758)	(0.073)
	Year Dummy	Yes			
	R^2	0.101			
	Wald-Chi Square	23.83***			
	$P(x^2)$	0.0006			
	Panel Data Model Type	Random			
	Hausman Test	3.48			
	Durbin Watson	2.00			

+p < 0.10; *p < 0.05; **p < 0.01; ***p < 0.001

Table 4: Regression results when financial proxy is FG
Dependent Variable: Corporate Social Responsibility

Model-4					
Independent Variable	Control Variables				
FG	Leverage	Size (Log of Total Assets)	Size (Log of Total Sales)	Risk	Age
0.58	-3.67***	-0.74	-0.49	2.11*	1.47
(0.015)	(-0.191)	(-0.887)	(-0.373)	(0.753)	(0.085)
	Year Dummy	Yes			
	R^2	0.085			
	Wald-Chi Square	16.56*			
	$P(x^2)$	0.0111			
	Panel Data Model Type	Random			
	Hausman Test	3.72			
	Durbin Watson	1.98			

+p < 0.10; *p < 0.05; **p < 0.01; ***p < 0.001

RESULTS AND DISCUSSIONS

As the table given above from 1 to 4 presents the results of the Generalized Least Square regression analysis using Corporate Social Responsibility (CSR) as the dependent variable and four accounting measures ROA, ROE, EPS and FG of financial performance as the independent variable, controlling for corporate debt, size in terms of total assets and total sales, risk and age. There are total 4 models in four tables and in all four models; CSR is taken as dependant variable. ROA as an independent variable presents the regression result in model 1. As social performance is strongly related to ROA at p < 0.001 in this model and significant at the p < 0.001 level. Results shown in table-1 give a strong indication that the linkage between CSR and FP is positive. In table-2 ROE is replaced by the ROA, however results remain highly significant for ROE and CSR link and this model is significant at the p < 0.001 level. The results are less strong, but still significant at p < 0.001 and p < 0.01 when EPS is used as a financial proxy in model 3. Lastly for firm growth as a measure of financial performance the results become insignificant in model-4. The results of random effect Generalized Least Square (GLS) regression analysis give a strong indication that the relation between accounting measures of financial performance and Corporate Social Responsibility (CSR) is positive and supports the hypothesis. The finding of this research is same with the findings of many previous studies that predict a positive nature of relationship between CSR and accounting measure of FP [32, 34, 37-39].CSR is a source of economic advantage as it helps to attract resources, attract the customer sympathies and attentions, reduces the potential internal and external conflicts like legal lawsuits from Government and other authorities so due to these factor researcher argue and suggest that there is a positive interaction between social conduct and financial performance.

Due to highly integration and growing social and moral responsibilities of different stakeholders ; stakeholders encourage the firms to take into consideration about their social, moral and ecological activities in the decision making, declaration of their mission, objects and disclosed their ways of conduct of CSR [6, 7, 40]. There are different classes of firm's internal and external stakeholders and in order to satisfy their social demands and avoid their negative confrontations like boycotts, complaints, objections, and protests etc its better for the business organization to take in consideration social commitments while taking their business decisions. Furthermore, society's expectations from corporate world are altered towards reciprocal relationship within ethical human values. Views are being established that with limited and scarce resources of world, not only government is not able to meet all the social needs of societies and fulfill all the expenditures of social issues thus, both public and private sector need to join hands and create mutual consensus to address social problems of surrounding [38]. Moreover, firms which are involved in illegal and irresponsible practices that are unfavorable for social welfare experience financial losses. This indicates the significant positive relationship between CSR and FP [39]. In addition, a large number of business managers believe that sound philanthropic practices not only improve a company's image among customers but may also be a competitive edge for that company [41]. Corporate social giving has always been perceived as a key factor to boost a company's image in a competitive business environment. Most of the corporate managers commit their companies to philanthropic practices to improve relationships with customers and establish a beneficial corporate image, which may help steer a company towards long term financial achievements [42].

Corporate debt, size risk and age of the firm are used as control variables in this study. Results reveal that there is no significant relationship between CSR and size of a firm in terms of both (total assets and total sales) in any model. In addition age of a firm is also insignificantly related to CSR. However, results strongly recommending the negative effect of corporate debt (leverage) on the social performance of corporations. As highly leveraged firms are associated with limited amount of free cash flows and this further restricted the firms from discretionary investments under the control hypothesis proposed by the[43]. When firms have few cash flows then they have little opportunity to invest in the traditional social programs and this established the negative relationship between leverage and CSR[44]. Moreover firms with high levels of corporate debt facing a very strict debt agreements with their creditors due to which they are reluctant to spend more on CSR and openly disclose their CSR information [45]. The right of debtors on the cash flows of firms is higher as compared to the shareholders therefore mangers give more priority to them. Due to this reason managers of highly leveraged firms even ignore those projects which are with positive net present value and this action aggravate if the earnings of the project target the bondholders or creditors[46].

Furthermore, results also supports that there is a positive relationship between CSR and risk. Societies and companies are facing increasingly troubling environment, featured by economic instability, competitive dynamism, eroding natural resources and exploited consumption patterns hence both are facing critical risk for mutual survivals. In such trouble and times CSR can be a source of sustainable solution, Such that both societies and companies co exist in harmony with each other. An interesting insight brought up by current study is the positive relationship between risk and CSR. In business environment of Pakistani we see that higher risk leads to higher CSR. Such findings have also been supported in different contexts for example [45] also found a significant positive association between the number of social responsibility programmes and beta values of systematic risk with respect to the USA firms. On one hand financially sound firms are frequently asked for more and more involvement in social welfare activities and investments. At the other end of spectrum there are those social activists who continuously target such firms more as compared to less successful firms [47, 48]. Therefore in order to reduce risk and social threats in the conditions of high risk companies used CSR as an element of reducing risk level.

Conclusion

Regarding the relationship between Corporate Social Responsibility (CSR) and Financial Performance (FP) the undertaken study has tried to provide the perennial answer of one basic question of this debate: weather there is any relationship exists between FP and CSR and if so then what is the nature of this relationship. In order to evaluate the relationship between FP and CSR more precisely current research used CSR and four different measures of FP. The findings of this study about the nature of relationship between CSR and FP suggest the positive relationship between. This positive relationship between CSR and FP reveals positive social behavior of Pakistani firms. Pakistani firms are contributing in the social wellbeing of society, improving the living standards by promoting education and better health facilities, protecting environment from hazardous changes. They are also taking good care of their employees in order to build their trust and confidence. In turn these social expenditures not only facilitate the firms to attain the continuous and long term sustainable development but also help them to achieve financial benefits as well.

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