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A Survey of the Relationship between social responsibility and financial performance

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ABSTRACT

In the modern commercial era, companies and their managers are subjected to well publicized pressure to play an increasingly active role in society – so called "Corporate social responsibility". It has been argued that an element in this development is simply enlightened self-interest in that social responsibility enhances corporate image and financial performance. To date the evidence to support this thesis derives from North America. Outside this continent evidence for any relationship is sparse. This study will initially attempt to define. The concept of corporate social responsibility and to examine its guiding principles. Subsequently, the available empirical research into the link between corporate social responsibility and economic performance will be evaluated this study examines different impacts of positive and negative CSR activities on financial performance of hotel, restaurant and airline companies, theoretically based on positivity and negativity effects. Findings suggest mixed results across different industries and will contribute to companies' appropriate strategic decision-making for CSR activities by providing more precise information regarding the impacts of each directional CSR activity on financial performance.

Introduction

It is no secret that many multinational enterprises (MNEs) have annual turnovers higher than that of the GDP of a significant number of less developed countries (LDCs) put together. At the same time, the grad-ual liberalization of trade at the global level, coupled with mounting external debt, lack of financial capital, and high unemployment in LDCs has resulted in many cases in the promulgation of enticing foreign investment legislation, rampant corruption, and lax control over the operations of MNEs, as far as the domestic law and enforcement by the host State is concerned. Since the addressees and bearers of human rights, labor, and environmental obligations under traditional treaty and customary international law have been States. Commentators have argued both for and against the view that corporate social responsibility is enlightened economic self-interest.

The controversy at the theoretical level will be considered here, while the empirical evidence for and against will be presented later. Similarly, in order to clarify what is a complex and at times convoluted debate, the discussion will be divided into the relationships suggested with:

• concurrent and subsequent (to CSR) economic performance; and

• past economic performance.

Those who have theorised that a negative relation exists between social responsibility and economic performance have argued that a high investment in social responsibility results in additional costs. According to McGuire *et al*. (1988, p. 855) the added costs may result from actions such as "making extensive charitable contributions, promoting community development plans, maintaining plants in economically depressed locations and establishing environmental protection procedures". These costs might put a firm at an economic disadvantage compared to other, less socially responsible, firms. In contrast, others have argued the case for a positive association. McGuire *et al*. (1988) cite the argument that a firm perceived as high in social responsibility may face relatively fewer labour problems or perhaps customers may be more favourably disposed to its products.

Alternatively, CSR activities might improve a firm's reputation and relationship with bankers, investors and government officials. Improved relationships with them may well be translated to economic benefits.

According to Spicer (1978a,b), Rosen *et al*. (1991), Graves and Waddock (1994) and Pava and Krausz (1996), a firm's CSR behavior seems to be a factor that influences banks and other institutional investors' investment decisions. Thus, a high CSR profile may improve a firm's access to sources of capital.

Corporate social responsibility

The pharmaceutical sector, an industry already facing stiff tests in the form of intensified competition and strategic consolidation, has increasingly become subject to a variety of other pressures. Significantly, in common with other large-scale businesses, pharmaceutical firms are being exhorted to respond positively to the challenge of corporate (social) responsibility (CSR). Clearly, for individual managers within pharmaceutical firms the issue of CSR in the form of closely connected questions relating to patient access to health treatment, patent protection and affordability presents major problems.

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Part of the burden of addressing the demands of CSR is the need to engage effectively with a range of stakeholders. Individual managers in pharmaceutical companies have to confront the complicated task of choosing which stakeholder dialogue practices to adopt and why. This real-world management predicament runs parallel to an academic interest in CSR stakeholder dialogue theory and models. Accordingly, this paper contributes to primarily to the academic debate by reviewing past attempts to theorise CSR and stakeholder dialogue, identifying gaps and weaknesses, and proposing a diagram-type model as a refined prototype framework.

The amount of literature available on CSR is massive and its production continues to grow. In addition, there is considerable literature on related concepts, such as 'business ethics', 'corporate citizenships' and 'sustainable business', to mention a few. The readings suggested here focus on literature that explicitly discusses CSR. The Reader is therefore not a complete review of CSR-relevant literature, but rather an attempt to organize this complex and vast area of literature . CSR refers to the obligations of the firm to society or, more specifically, the firm's stakeholders—those affected by corporate policies and practices. Saltaire and other early examples of paternalistic capitalism reveal three important characteristics of CSR. First, it is not a new idea, the hype surrounding it today notwithstanding Second, firms engaging in CSR often have "normative case" for CSR. Third, while there is substantial agreement that CSR is concerned with the societal obligations of business, there is much less certainty about what these obligations might be or their scope. Salt's ideas for social betterment did not meet with universal approval and he opposed legislation to prohibit child labor. Even corporate champions of CSR today, such as Starbucks meet with opposition from NGOs (non governmental organizations) and others. As Sethi observed nearly 30 years ago, the operational meaning of corporate social responsibility is supremely vague and, he suggested, it can mean all things to all peopleThese three characteristics of CSR are particularly important as we consider its recent rise to prominence and the challenges it poses.

Bowen (1953) sets the scene in this field by suggesting that the concept of specifically corporate social responsibility emphasizes that:

• businesses exist at the pleasure of society and that their behaviour and methods of operation must fall within the guidelines set by society; and

• businesses act as moral agents within society.

Wood (1991) expanded these ideas, encapsulating them into three driving principles of social responsibility, which are that:

(1) business is a social institution and thus obliged to use its power responsibly;(2) businesses are responsible for the outcomes relating to their areas of involvement with society; and (3) individual managers are moral agents who are obliged to exercise discretion in their decision making. In general, the social responsibilities of a firm seem to arise from the intersection (and compatibility) of the political and cultural systems with the economic system (Jones,1983). However, Friedman (1970) argued that the successful functioning of our society depends on the role specialisation of its institutions (or systems). According to him the corporation is an economic institution and thus should specialise in the economic sphere; socially responsible behaviour will be rectified by the market through profits. In Friedman's (1970) view business has only one social responsibility and that is to maximise the profits of its owners (to protect their property rights). Organisations are seen purely as legal entities incapable of value decisions. A manager who uses a firm's resources for non-profit social purposes is thought to be diverting economic efficiency and levying an "illegal tax" on the organisation. Opponents (Frederick *et al.*, 1992) of this view, challenge the very foundations of Friedman's thesis – the economic model. They claim that the economic model and role specialisation of institutions (or systems) are not working as suggested.

This comes as a result of the rise of oligopolies in certain sectors; the separation of ownership and management; government's involvement in the economy and conversely industry's involvement in the political process through lobbying. In addition, if corporations do not adopt "social responsibility", government with its potential for inefficiency and insensitive bureaucratic methods may be forced to step in. With respect to Friedman's argument that the legal conception of corporations' articles and memorandums of associations limits a firm's involvement solely to economic roles, it can be claimed that they are broad enough to allow departures from this narrow path.

Social responsibility is also seen as a consequence of and an obligation following from the unprecedented increase of firms' social power (as tax payers, recruiters, etc.) (Davis, 1975). Failure to balance social power with social responsibility may ultimately result in the loss of this power and a subsequent decline of the firm (Davis, 1975).

Another school of thought sees social responsibility as a contractual obligation firms have towards society (Donaldson, 1983). It is society in the first place that has permitted firms to use both natural and human resources and has given them the right to perform their productive functions and to attain their power status (Donaldson, 1983).

As a result, society has an implicit social contract with the firm. Thus, in return for the right to exploit resources in the production process, society has a claim on the firm and the right to control it. The specifics of this contract may change as social conditions change but this contract in general always remains the basis of the legitimacy of the demand for or assertion of the need for CSR (Epstein, 1987).

A growing number of scholars take the view that firms can no longer be seen purely as private institutions but as social institutions instead (Frederick *et al.*, 1992; Freeman, 1984; Lodge, 1977). The benefits flowing from firms need to be shared collectively. This thesis is similar to the stakeholders model (Freeman, 1984) and claims that a firm is responsible not only to its shareholders (owners) but to all stakeholders (consumers, employees, creditors, etc.) whose contribution is necessary for a firm's success. Thus, CSR means that a corporation should be held accountable for any of its actions that affect people, communities and the environment in which those people or communities live (Frederick *et al.*, 1992).

Carroll (1979) suggests that CSR is defined as the economic, legal, ethical and discretionary demands that society places on business. Similarly, Zanies conceptualized CSR as the degree of "fit" between society's expectations of business and the ethics of business. He argues that CSR is really nothing more than another layer of managerial responsibility resulting from the evolution of capitalism. An interesting twist to the argument is provided by Tuzzolino and Armandi (1981) who provide a motivational theory of organisational social response based on Maslow's hierarchy of needs. CSR is the fulfilment of a firm's

"internal and external self-actualisation needs" which are located on the top of their organisational needs pyramid.

According to this view, firms adopt CSR after they have satisfied three earlier layers of needs (which include: "physiological" or survival needs fulfilled by corporate profits; "safety needs" such as dividend policy, conglomeration and competitive position; and "affiliative needs" such as participation in trade association, lobby groups, etc.). Epstein (1987) attempted to differentiate "business ethics" and CSR and to incorporate them into a strategic process. According to him "business ethics" refer to issues and dilemmas related to the morality of organisational actions or decisions. CSR focuses more on the consequences of organisational actions. He defined CSR as the "discernment of issues, expectations and claims on business organizations regarding the consequences of policies and behaviour on internal and external stakeholders" (Epstein 1987, p. 101). Angelidis and Ibrahim (1993) defined CSR as "corporate social actions whose purpose is to satisfy social needs". They developed an equilibrium theory based on social demand and supply, identifying a set of factors that affects them (social supply and demand).

Thus, opinions differ in terms of the basis or scope of CSR and even the very definition of the term. As a consequence different aspects of a firm's operations can be seen to come under its sway – depending on the stance one adopts. As has been shown, what can be conceived as "social responsibility" can range from simply maximisation of profits, to satisfaction of stakeholders' social needs, or fulfilment of social contractual obligations, fulfilment of a firm's needs, achievement of a social equilibrium, etc. – depending on the stance taken.

While academic debate abounds at the theoretical level, at the operational level insights are more sparse. Schwarts and Dahl observed that socially acceptable behaviour of North American firms at the time of writing – the 1970s included:

- disclosure of information to shareholders;
- disclosure of the board of directors;
- monopolistic behaviour (predatory pricing, etc.);
- equality of treatment for minorities;
- profit sharing;
- environmental protection;
- ethics in advertising; and
- social impact of technology.

However, according to Vyarkarnam (1992), many of these have now been regulated by statute. Present day concerns have changed focus. He found that current CSR concerns, which are in substance the same for both North American and the UK firms, encompass such areas as:

- environmental protection (e.g. reduction of emissions and waste and the recycling of materials);
- philanthropy (donating to charities, etc.);
- involvement in social causes (involving anything from human rights to AIDS education);
- urban investment (working with local government to regenerate small businesses and the inner city environment generally);and
- employee schemes (higher standards of occupational health and safety, good standard of staff treatment, job-sharing, flexitime, etc.).

Empirical research into the effects of corporate responsibility has produced mixed results. Some studies have suggested a positive relation, whereas others have concluded that the effects are negative or inconsequential. For example, Belkaoui (1976) investigated the information content of pollution control disclosures. His results suggested a positive relationship between economic performance and social responsibility, at least in this area. Other studies produced results consistent with the notion that corporate social responsibility activities impact on the financial markets (Anderson and Frankle, 1980; Shane and Spicer, 1983; Spicer, 1978a,b). However, certain studies have replicated earlier research and found conflicting results. Frankle and Anderson (1978) rejected Belkaoui's (1976) interpretation and argued that non-disclosing firms had consistently performed better in the market. In a similar manner, Chen and Metcalf (1980) disagreed with Spicer's (1978a,b) conclusions, arguing that his results were driven by spurious correlations. In response Spicer (1980) stated that Chen and Metcalf (1980) misinterpreted the purpose of his study, emphasising that associations not causal relationships were being investigated.

Ingram (1978) concluded that the information content of social responsibility disclosures was conditional on the market segment with which a firm is identified. Alexander and Bulcholz (1978) and Abbott and Monsen (1979) found no significant relationship between a corporation's level of social responsibility activities and stock market performance.

In addition, Chugh (1978), Trotman and Bradley (1981) and Mahapatra (1984) concluded that corporate social responsibility activities may lead to increased systematic risk.

Cochran and Wood (1984) used corporate social responsibility rankings developed by Moskowitz (1972) to test the relationship between corporate social responsibility activities and firm's performance. After controlling for industry classification and corporate age, a weak positive association between corporate social responsibility activities and economic performance was found. Mills and Gardner (1984) concluded in their analysis of the relationship between social disclosure and economic performance, that companies are more likely to disclose social responsibility expenditures when their financial statements indicate favourable economic performance.

One drawback of the above empirical studies is that they failed to distinguish between past, concurrent and subsequent to CSR economic performance, and thus to make possible reliable inferences about direction of causation. In most of the previous studies, economic performance covered a (commonly five year) period "surrounding" the CSR performance and/or social disclosure periods. Routinely, the CSR performance and/or social disclosure periods were the midpoints of that period. However, in Mahapatra (1984) and Mills and Gardiner (1984) studies, economic performance periods were concurrent to the CSR performance period.

Only Shane and Spicer (1983) looked at economic performance subsequent to CSR disclosure period, finding a positive association. Practically, McGuire *et al.* (1988) were the first to break this tradition and to separate economic performance into past, concurrent and subsequent to CSR performance. They used Fortune magazine's ratings of corporate reputations to analyse the relationship between perceived corporate social responsibility and economic performance. Prior economic performance of the firms, as measured by both stock market returns and accounting based measures, were found to be more closely related to corporate social responsibility than was subsequent economic performance.

McGuire *et al.* (1988) suggested that economic performance may be a variable influencing Thus, the empirical research into

the relationship between corporate social responsibility and economic performance is confusing and far from conclusive. According to Ullmann (1985) this may be attributed to the use of varying and questionable measures of CSR, differences in the research methodologies and the financial performance measures used. To overcome these limitations, this study will use a more comprehensive measurement of CSR performance (admittedly within the context of the UK social and business environment), a combination of economic performance measures and including the necessary intervening variables in the research design.

CSR and financial performance

A modern concept of CSR has evolved since the 1950s, formalized in the 1960s and proliferated in the 1970s (Carroll, 1999). Based on various studies from the CSR literature (Carroll, 1999; Engardio et al., 2007; Hart, 1995; Holme and Watts, 2000; McWilliams and Siegel, 2001; Nicolau, 2008; Tsoutsoura, 2004), CSR can be broadly defined as the activities making companies good citizens who contribute to society's welfare beyond their own self interests. Throughout the past several decades, numerous aspects of CSR have been the subject of investigation in academic and business literature, and according to the framework of Schwartz and Carroll (2003), economic, legal and ethical domains can be epitomized as the most common components of CSR.

One aspect of CSR interesting to many financial economists is the economic domain: financial impact of CSR for profit-seeking corporations. Regarding the relationship between companies' CSR activities and their performances (especially, financial performance), the literature presents three assertions.

The first group of researchers, based on the viewpoint of Friedman (1970), has found a negative relationship between CSR activities and financial performance as measured by, for example, stock price changes (Vance, 1975), excess return (Wright and Ferris, 1997), or analysts' earnings-per-share forecasts (Cordeiro and Sarkis, 1997). Friedman argued that managements are selected by the stockholders as agents and their sole responsibility is acting on behalf of the principals' best interests. From Friedman's perspective, the one and only social responsibility of business is to use its resources and engage in activities designed to increase profits and wealth of owners. Any other activities disturbing the optimal allocation of scarce resources to alternative uses exert an adverse influence on firm performance.

The second group argued for positive impact from companies' CRS activities on financial performance (Arago´ n-Correa et al., 2008; Bird et al., 2007; Bragdon and Marlin, 1972; Klassen and McLaughlin, 1996; Nicolau, 2008; Orlitzky et al.,1997). This group's assertion, based on stakeholder theory (Freeman, 1984), suggests that firms expand the scope of consideration in their decision-making and activities beyond shareholders to several other constituencies with interests, such as customers, employees, suppliers and communities. The second group asserts that CSR activities, which encompass all legitimate stakeholders' implicit claims as stakeholder theory suggests, can improve firm value by (1) immediate cost saving, (2) enhancement of firm reputation, and (3) dissuasion of future action by regulatory bodies including governments which might impose significant costs on the firm (Bird et al., 2007). A third group has supported no particular relationship between CSR activities and financial performance (Abbott and Monsen, 1979; Alexander and Buchholz, 1978; Aupperle et al., 1985; Teoh et al., 1999), partially arguing for the existence of too many confounding factors for researchers to uncover a particular impact from CSR on firm performance.

Seemingly contradictory themes between Friedman's (1970) viewpoint and the stakeholder theory arise from the assumption that CSR, which considers the interests of a broad spectrum of stakeholders (suggested by stakeholder theory), is in fact detrimental to value maximization activities of the firm (asserted by Friedman's viewpoint). However, Jensen (2001) attempted to reconcile the potential conflict between these two viewpoints by proposing enlightened stakeholder theory, which asserts that a firmcannotmaximize its long-term value if it ignores the interests of diverse stakeholders. And, according to Post et al. (2002), a firm's capacity that generates sustainablewealth over time and its long-term value are determined by the relationship with both internal and external stakeholders. CSR, if it contributes to enhancing firm value, can be an appropriate corporate strategy as the stakeholder theory suggests, not an exploitation of shareholders' wealth to benefit other parties, as Friedman (1970) worried.

Conclusion

Modern corporate stakeholder theory (Cornell and Shapiro, 1987; Freeman, 1984; Jones, 1995; McGuire *et al.*, 1988) can also explain part of the CSR/economic performance relationship. According to stakeholder theory the value of a firm is related to the cost of both "explicit claims" and "implicit claims" on a firm's resources. Claimants include not only the legal owners of the firm but other constituencies such as lenders, employees, consumers, banks, government, etc. Stakeholders who have explicit claims on the corporation include – besides its owners – lenders, employees, government, etc. In addition, there are others with whom the firm has made implicit contracts, which could include the quality of service and CSR. According to McGuire *et al.* (1988), if the firm does not honour these implicit contracts, then it is argued that the parties to these contracts may attempt to transform them from implicit to explicit agreements. The latter may be more costly for the firms involved. According to Freeman (1984) and McGuire *et al.* (1988) the implications of the conversion of " implicit" to "explicit" contracts may have broader effects than the direct costs resulting from the forced change in its behaviour (e.g. cost of installment of gas emission control equipment). For example, socially irresponsible actions in one area (e.g. gas emissions) may spill-over and affect the corporate image in other areas as well (e.g. unregulated issues on labour relationships).

This could in turn result in other implicit stakeholders (e.g. trade unions) striving to make their claims explicit. Thus, firms with an image of high CSR may find that they face both fewer and lower-cost explicit claims than those with a less enlightened stance. Thus, from a theoretical perspective, arguments can and have been made both for and against a positive relationship between social responsibility and concurrent or subsequent (to CSR) economic performance. According to Parert and Eibert (1975), Ullmann (1985) and Roberts (1992), if corporate social responsibility is viewed as a significant cost, firms with relatively high past financial performance may be more willing to absorb these costs in the future. It is also expected that poor performers would seek more immediate results and consequently they may prefer short-term and high-yield investments to the uncertain and in general longer-term CSR investments. A similar view is that policies and expenditures in discretionary areas such as social programmes may be especially sensitive to the existence of "slack" resources in the firm (McGuire *et al.*, 1988).

Ullmann (1985) argued that corporations must reach an acceptable level of economic performance before devoting company resources to meet social demands. This is supported by the assertion that corporations with strong prior economic performance appear to be more likely to have high current levels of social disclosure. Ullmann (1985) also suggested that companies with less stable stock market patterns would be relatively less likely to commit resources to social activities.

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