Impact of Corporate Social Responsibility on Financial Performance of Corporations: Evidence from Pakistan

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Abstract

This paper estimates the relationship of corporate social responsibility, financial performance, market value of the share and financial leverage . In this particular study, 156 listed companies on Karachi Stock Exchange (KSE) from textile sector, chemical sector, cement sector and the tobacco sector are taken. The observations are taken for the entire period of 2010 and 2011 from the published resources of state bank of Pakistan. In aggregate, the results of the study conclude that corporate social performance (CSR) has no effect on financial performance (CFP) . It is obvious from the results that CSR has negative effect on the market value of the share but no relationship to D/E behavior of the firm, significantly. Moreover, the investors do not have the same level of information as the information is captured by the management about the company affairs. In addition, the debt singling hypothesis indicates that the further incorporation of debt into capital structure should influence the behavior of the investor, regarding to the investment in the shares positively, but due to information asymmetry, it is negative. This study further provides the room to test the model of effect of CSR on stock returns in a portfolio construction.
Key words: Corporate Social Responsibility, Financial Performance, Market Performance, Market Value.

Introduction

In recent years, there has been a growing interest, both in the academic as well as the business world, around the issue of Corporate Social Performance (CSP) - a multidimensional measure (Carroll, 1991; Griffin and Mahon, 1997) of corporate social responsibility (CSR) that captures firm actions aimed at engaging a broader set of stakeholders and ranging across a wide variety of inputs, internal routines or processes, and outputs (Waddock and Graves, 1997; Wood, 1991; Aupperle et al., 1985; Wolfe and Aupperle, 1991; Aupperle, 1991; Miles, 1987; Gephart, 1991). In the literature to date, perhaps the most studied aspect of CSR has been its (potential) link to Corporate Financial Performance (CFP). Much work has focused on understanding this link and a number of theoretical insights and empirical findings have been revealed in the process. However, the causal directionality of this link has by no means been established. Different theories predict conflicting directionality and a number of empirical studies have found inconsistent results.

Previously, scholars within the neoclassical economics tradition argued theoretically that CSR strategies unnecessarily raise a firm's costs, thus creating a competitive disadvantage vis-à-vis competitors (Friedman, 2007; Aupperle et al., 1985; McWilliams and Siegel, 1997; Jensen, 2002). Arguing from an agency theory perspective (Jensen and Meckling, 1976) other studies have suggested that employing valuable firm resources for positive social performance strategies results in significant managerial benefits rather than financial benefits to shareholders (Brammer and Millington, 2008).

On the other hand, scholars have argued that enhanced social performance may lead to obtaining better resources (Cochran and Wood, 1984; Waddock and Graves, 1997), higher quality employees (Turban and Greening, 1996; Greening and Turban, 2000), better marketing of products and services (Moskowitz, 1972; Fombrun, 1996) and it may even lead to the creation of unforeseen opportunities (Fombrun, Gardberg and Barnett, 2000).

Corporate Social Responsibility (CSR) has become a hot topic in today's business landscape. In Pakistan, this movement is only few years old. The companies in Pakistan are now frequently surveyed by credit rating agencies in order to achieve their stakeholder management and to progress their particular interest. Yet the status of CSR in Pakistan is at its premature stage. There are only few companies which have an existing CSR strategy and most of them are the multinationals that pursue their own corporate social responsibility parameters and set of standards. Unfortunately, it seems that the domestic industry is either ignorant of the paybacks brought by corporate social responsibility or they consider that even if they do not take on such parameters, they will not suffer any state of risk. In the year 1996, indifference of the domestic business sector was highlighted. Waheed (2005), by using the corporate data, developed the report regarding to CSR compliance in Pakistan for RBI, (Responsible Business Initiative). Continuous development is becoming a more famous subject, and the empirical researchers are getting interested in awareness of how stakeholder management can transport enhanced financial performance and how well it is performing in the equity and debt market. The ethical funds are supposed to be outperforming the market indices, and the managers now wonder if they should create value for their shareholders or down all their stakeholders. In the past, researchers have studied the relationship between financial performance and company's social responsibility or social performance, but results remain unconvincing (Roman et al., 1999). this paper estimates a three-equation structural model, based on a theory that relates corporate financial performance (CFP), corporate social responsibility (CSR), and market performance (MP) regarding the firm's share value and relative debt level. This particular study will use a new source of data on corporate social performance regarding the Pakistan perspective. The study will find out the

relationship of corporate social performance with financial performance and how it generates signals for the market participants as well. This study also confirms the necessity to control models for investment in financial assets. Furthermore, this study will also confirm the necessity to design models for investment in financial assets. The ultimate objective of this study is to deal with the issue of the relationship between corporate social and financial performance and the market value of the firm by making choices of the equity and debt.

Literature review:
The empirical literature examining the relation between CSR and corporate financial performance is extensive. As discussed previously, however, the results are generally mixed, which could be attributed to the various ways corporate financial performance and CSR have been operationally defined (Carroll, 1979; Orlitzky et al., 2003), to the lack of appropriate statistical controls (Margolis and Walsh, 2003; Wood and Jones, 1995), or to the 'stakeholder misalignment' problem (Wood and Jones, 1995; Akpinar et al., 2008).

Typically used firm performance variables are accounting-based measures such as ROE and ROA, and the market-based measure such as Tobin's Q. As for corporate social performance, existing studies have used a diversity of measures. Earlier studies relied on various reputational indices, such as Moskowitz's (1972, 1975) tripartite ratings of 'outstanding', 'honorable mention', and 'worst' companies (Cochran and Wood 1984; Sturdivant and Ginter 1997), or the Fortune's ratings of a corporation's responsibility to the community and environment (Conine and Madden 1987; Fombrun and Shanley 1990; McGuire et al. 1998). Another widely used index is the measure provided by the Council on Economic Priorities (CEP) based on social audits. Various studies have used the CEP social audit ranking of companies' pollution records (Bragdon and Marlin 1972; Fogler and Nutt 1975; Spicer 1978; Blackburn et al., 1994). Table 1 provides a summary of selected empirical studies where the second column indicates the statistical relation between CSR and corporate financial performance. As shown in the table, some studies report a positive relation while others report a mixed or negative relation. In regards to the mixed evidence, McWilliams and Siegel (2000) stress the importance of including other variables that are acknowledged to be important determinants of corporate financial performance. For example, they show that, once R&D investment is included in the equation, the positive relation between CSR and corporate financial performance is no longer significant.

The so-called 'stakeholder misalignment' problem suggested by Wood and Jones (1995) is that of relating stakeholder-specific variables to a set of aggregated stakeholder variables ignoring many differences between different stakeholder groups. They argue that the research on CSR should take into account the fact that a company should weigh which sub-dimensions of social performance are perceived to be important by its stakeholders. To circumvent the stakeholder misalignment problem, Lev et al. (2008) classify firms into two groups based on the degree of sensitivity to consumer perceptions. The first group consists of firms belonging to industries where sensitivity to consumer perception is high such as consumer goods and finance industries, and the second group has firms operating in industries where sensitivity to consumer perception is low. They empirically show that firms producing goods and services purchased by individual consumers are more likely to enhance their revenue from having a reputation as a good corporate citizen than firms that produce goods and services for industrial or government use. Akpinar et al. (2008) measure CSR by a stakeholder-weighted CSR index which aggregates the index scores for CSR sub-dimensions after taking into account stakeholder conflicts and varying importance of different CSR sub-dimensions in different industries. They find a significantly positive association between CSR

and corporate financial performance when the stakeholder-weighted CSR index is used to measure CSR. Our paper is also in the same vein as Akpinar et al. (2008) in that we develop a stakeholder-weighted CSR index.

Table 1. Summary of Selected Empirical Studies

Authors	Sign	Measure of CSR	Measure of firm Performance
Bragdon and Marlin (1972)	(+)	CEP index	EPS growth, ROE, ROC
Bowman and Haire (1975)	(+)	Carroll's (1979) CSR construct and CEP index	ROE
Fogler and Nutt (1975)	neutral	CEP index	P/E ratio
Sturdivant and Ginter (1977)	(+)	Moskowitz reputation index	EPS growth
Alexander and Buchholz (1978)	(+)	Reputation ratings	Market return on security
Spicer (1978)	(+)	CEP index	ROE
Cochran and Wood (1984)	(+)	Moskowitz reputation index	Abnormal return
Aupperle et al., (1985)	(-)	Carroll's (1979) CSR construct	ROA
Conine and Madden (1987)	(+)	Erdos and Morgan's corporate	Perceptual/expectational survey measures
McGuire et al. (1988)	mixed	Fortune index	ROA, sales growth, asset Growth
Fombrun and Shanley (1990)	neutral	Charitable contributions, Fortune index	ROIC, market-to-book ratio
Teoh and Shiu (1990)	neutral	CSR disclosure	Institutional investors' survey questionnaire
Blackburn et al. (1994)	(+)	CEP index	ROA, abnormal return, EPS
Waddock and Graves (1997)	(+)	KLD index	ROA, ROE, return on
Berman et al. (1999)	(+)	KLD index	ROA
Teoh et al. (1999)	neutral	Divestment from South Africa	Abnormal return
McWilliams and Siegel (2000)	neutral	KLD index	ROA
Orlitzky et al. (2003)	mixed	KLD index	P/E ratio, ROE, ROA
Akpinar et al. (2008)	(+)	KLD index	Stock return, Tobin's Q
Lev et al. (2008)	(+)	Charitable contributions	Sales growth

Development of Hypothesis
Four major hypotheses are developed for further investigation. They are as under.
H1: Higher corporate social performance results to an increase in the market value of the share.
H2: Financial performance mediates corporate social performance and the market value of the share.
H3: Higher corporate social performance results to an increase in the debt level of the Firm.
H4: Financial performance mediates corporate social performance and the debt level of the firm.

Data and methodology

In this research study, 156 listed companies are considered from textile sector, chemical sector, cement sector and tobacco sector, listed on Karachi stock exchange. The observations are taken for the entire period of 2010 and 2011 from the published resources of state bank of Pakistan.

Measure of corporate social performance

Waheed (2005) developed the report by using the corporate data regarding CSR compliance in Pakistan. By using the study and the criteria given by Waheed (2005), we computed the values for corporate social performance index for each sector. The variables taken by Waheed (2005) in this computations were: Corporate governance (CG), business ethical principles (BE), environmental compliance (EC), social compliance (SC), disclosure environmental and social report (DR), product integrity (PI), corporate giving's and community investment, stakeholders dialogue(SH), financial performance (FP) and supply chain security (SS). To compute relationship between the CSP and financial performance, we excluded the score of financial performance to avoid the similarity in data problem. The 9 parameters for CSR/CSP are represented in Table 2.

Table 2. Computation of CSR/CSP for the year 2010.

Sector	CG	BE	EC	SC	DR	PI	CC	SH	SS	Average CSP	CSP weighted index
Chemicals	5	3	5	4	4	5	5	4	3	4.75	0.14068
Textile	2.5	0.9	2.1	3	2	4	2.8	3	1.8	2.7625	0.08182
Cement	4	3	1	2	0	4	3	3	2	2.75	0.08145
Oil and Gas	4	2	4	4	3	4	4	4	3	4	0.11847
Footwear	1	0	1	4	4	1	2	3	3	2.375	0.07034
Sugar	3	0	3	4	4	5	4	2	3	3.5	0.10366
Tobacco	4	3	2	4	3	5	1	4	4	3.75	0.11106
Telecom	3	3	2	4	2.3	5	4	4	3	3.7875	0.11218
Consumer	5	2	3	5	0	5	4	0	5	3.625	0.10736
Financial	3	2	0	3	1.2	5	2	2.5	1	2.4625	0.07295

The maximum score for each criterion is 5, and the attained score by each sector is given in Table 2 and then weighted CSP index is computed on the grounds of how much proportionate weight of CSR practices is followed by each sector.

Measure of financial performance
Two measures are used to compute the financial performance of the firms: Return on assets and Return on equity.

Table 3. Descriptive statistics.

Variable	Range	Minimum	Maximum	Mean	Standard deviation	Variance
D/E	9.01	0.11	9.12	0.7104	0.61006	0.372
ROA	8.34	-1.08	7.26	0.0414	0.35513	0.126
ROE	31.79	-18.39	13.40	-.1101	1.63064	2.659
Size	9.22	1.63	10.85	7.0922	1.49675	2.240
CSP	.07	0.08	0.15	0.1111	0.03157	0.001
MVS	539.95	0.05	540.00	34.5409	54.20513	2938.197

Measure of market performance
The market value of the share is used as a measure of market performance of the firms.
Measure of debt performance
Average measure of debt performance is used on the basis of: Total debt to total equity; Total debt to total capital employed
Measure of size of the company
Natural log value of the total assets is used as a measure of the size of the company.

Results and Discussion
According to financial performance indicators, Table 3 provides the mean value of ROA and ROE, 4.14 and - 11.01%, respectively, with standard deviation 0.35 and 1.63, respectively. According to Table 2, market performance indicates that the mean value of the market value of the share remained Rs. 34.5409. The maximum price of the share remained Rs. 540 and the minimum value remained Rs. 0.05 with a standard deviation of Rs. 54.20. Based on a measure initially developed by Waheed (2005), CSR/CSP measure consists of 9 items as indicated in Table 2. The mean and standard deviation for CSP for 4 sectors is 0.1111 and 0.031 57. The mean and standard deviation of total assets of the sampled companies are natural logged values 7.092 and 1.49675, respectively. By converting these values into actual numbers, the mean value is Rs.1202.505 million and the standard deviation is Rs 4.467 million. Financial leverage is the financing mix of external debt, equity and internal capital used to finance the company's assets. The mean and standard deviation of debt to equity of the sampled companies were 71.041 and 61%, respectively. The aforementioned discussed facts and figures are reported in the Table 3.

Table 4 represents the degrees of relationship between the debt to equity, ROA, ROE, Size, CSP and market value of the share. The reported results are quite interesting and states that the financial leverage (debt to equity ratio) have significant correlation of 0.10 at 0.05 level of significance. This result supports the argument that the more the firm takes the risk the greater the level of returns.

Here, the firms with high financial leverage have relationship with the positive stream of returns on the asset. Moreover, the D/E ratio has negative correlation with ROE -0.069 but not significant. Greater size of the financial leverage has negative relationship with ROE. D/E ratio is negatively correlated with the size of the company with r = -0.352 at 0.01 level of significance which indicates that as the size increases, a company is more externally financed by debt. Table 2 indicates that the normal average financing mix for these samples companies is 71% debt and 29% equity.

Table 4. Correlation matrix.

Variable	D/E	ROA	ROE	Size	CSP	MVS
DE	1					
ROA	0.100*	1				
ROE	-0.069	-0.421**	1			
Size	-0.352**	-0.130**	0.076	1		
CSP	0.037	-0.015	-0.029	-0.207**	1	
MVS	-0.075	0.030	0.050	0.241**	-0.125**	1

*Significant at 0.05 level; **significant at 0.01 level.

Table 5. Regression analysis.

Regression model	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Dependent variable	MV of share	ROA	MV of share	D/E	D/E	M V of share
Independent variable	CSP	CSP	ROA	CSP	ROA	D/E
R2	0.016	0.000	0.001	0.001	0.010	0.075
R2 adjusted	0.014	-0.002	-0.001	-0.001	0.008	0.006
F-Value	7.816	0.114	0.437	0.676	5.019	2.082
Beta	-0.125	-0.015	0.030	0.037	0.100	-0.075

| P-value | 0.005 | 0.736[a] | 0.509[a] | 0.411 | 0.026 | 0.095 |

[a]Significant at 0.05 level

The important element in this discussion is that the D/E has negative correlation with the market value of the share price but it is not significant. This negative relation-ship indicates that with an increase in debt financing by the firm, the external investors feels that the company is in financial crises and they try to withdraw their investment. Corporate social performance has insignificant relationship with the D/E level of the firm but it has a positive correlation which ultimately indicates that, to become socially responsible, the firms have to incorporate financing through external resources to meet the current industry and competitive challenges. Table 4 indicates that, ROA has -0.130 correlation at 0.01 level of significance which indicates that, the greater the size of the firm, the returns will be distributed over greater size of assets which ultimately decrease the level of ROA. ROA has insignificant correlation with the CSR. However, there is a negative relationship between ROA and CSP. ROA also has insignificant correlation with the market value of the firm but there is a minor positive relationship between ROA and market value of the share price. It may be inferred that, firms with high profitability will be perceived by external investors to better perform in the market. The size of the firm has significantly negative correlation of - 0.207 at 0.01 with the CSR. However, size of the firm has significantly positive correlation of 0.241 at 0.01 level with the market value of the firm. CSR has significant negative correlation of -0.125 at 0.01 with the market value of the share price of the company and rejects the H1. This study tests the direct effect of CSR, financial performance and market performance using variables of company CSR, ROA, ROE, MVS, size and financial leverage. As indicated in Table 5 (Models 1 and 5) are significant except for Models 2, 3 and 4, and 6 at < 0.05. Based on Table 5, testing the hypothesis H1 indicates there is significant effect of CFP on market value of the share (= -0.125, p(sig) = 0.005).

Table 5 indicates that the findings of Model 2 (= -0.015, p(sig.) = 0.736) fails to explain the relationship and impact of CSR on ROA. Model 3 (= 0.030, p(sig.) = 0.509) indicates that ROA has no effect on market value of the share and hence H2 is rejected. The aforementioned results of Model 2 is not consistent with the conditions of the study of Wadock and Graves (1997) supporting the positive relationship between CSR and CFP. However, the result of test in present study is consistent with the study of Mahoney and Roberts (2007), implicitly based on good management theory, for ROA and ROE model. As indicated in Table 5, the result of test of interaction of D/E and CSP (= 0.037, p(sig.) = 0.411) indicates that CSR does not effect the financial leverage of the firm and rejects H3. Models 2 and 4 also rejects H4 but Model 5 with = 0.100, p(sig) = 0.026 accepts H4. In aggregate, H4 is rejected. However, Model 5 with = 0.100, p(sig) = 0.026 indicates that the firms riskiness has positive impact on the firm ROA. The increased level of the financial leverage of the firm enhances the profitability. It is argued that, with an increase in risk level, the profitability increases and hence, Model 5 indicates this particular scenario. Model 6 is just taken into consideration to know the relationship and effect of D/E on the market value of the share. Hence, Model 6 (= -0.075, p = 0.095) is in-significant at 0.05 level.

Conclusion

In aggregate, the results of this study conclude that corporate social responsibility (CSR) has no effect on financial performance (CFP). It is obvious from the results that CSR has negative effect on the market value of the share but no relationship to D/E behavior of the firm significantly. In addition. However, on the basis of whole analysis, it may be argued that the linkage between CSR and financial performance is spurious as concluded by Orlitzki (2000). It is concluded that there exist some limitations. Fauzi (2007) concluded the limitations of relatively low number of sampled companies and their reporting period as matched to the prior studies such as Wardock and Graves (1997) and Mahoney and Roberts (2007) who had used

more than three hundred companies and period coverage of four years in their sample consideration. Results reveal the same limitations, along with the actual consideration of CSR parameters by each industry or sector for the latest years. Furthermore, we conclude that principals are more concerned with the wealth maximization goal of the firm rather than the profitability objective of the firm. Moreover, the investors do not have the same level of information as the information is captured by the management about the company affairs. In addition, the debt singling hypothesis indicates that the further incorporation of debt into capital structure should influence the behavior of the investor, regarding the investment in the shares as positive, due to information asymmetry being negative. This study provides the room to test the model of effect of CSR on market return in designing an efficient portfolio with lower CSR firms and higher CSR firm's categorization.

Limitations

The results of the research must be interpreted carefully and thoroughly. This is related to a number of limitations which can be used as a basis for making recommendations. As for some of the limitations that can be found among others:(1) Relatively limited number of samples, namely 156 companies listed on the Karachi Stock Exchange (KSE). The limited number of companies are eligible to be caused by a sample of this study are still a few companies listed on the Stock Exchange which revealed a consistent CSR activities throughout the study period and voluntary CSR disclosure.
(2) The research sample is limited to Chemicals, Cement, Tobacco and Textile companies so that these results cannot be generalized to other industries.
(3) Disclosure of CSR is voluntary so there is no standard rule of the regulator which can be used as reference to measure CSR index. This raises the subjectivity element in measuring CSR index.

Directions for Future Research

Based on some of the limitations of the study above, the following are some considerations that need to be considered in developing and expanding this research:
(1) Further research is recommended to multiply the number of samples and use the data the most recent annual report to describe the condition of the most recent.
(2) Future studies are expected to conduct research in all industry sectors, not just Chemicals, Cement, Textile and Tobacco companies only for the results obtained to represent all industrial sectors listed in Karachi Stock Exchange (KSE).
(3) Future studies should use data with a longer period to obtain a more valid measurement results.
(4) Future studies are expected to connect a Corporate Social Responsibility to the value of the company.

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