Corporate social responsibility and financial performance: A non-linear and disaggregated approach

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A B S T R A C T

The present paper examines the relationship between Corporate Social Performance (CSP) and Corporate Financial Performance (CFP), using both accounting-based (Return on Assets and Return on Capital) and market-based (Excess Stock Returns) performance indicators. We use Bloomberg’s Environmental Social Governance (ESG) Disclosure score covering the S&P500 firms in the period 2007–2011 which allows for the examination of both linear and nonlinear relationships to be considered. The results of the linear model suggest that there is a significant negative relationship between CSP and Return on Capital. However, the non linear models provide evidence of a U-shaped relationship between CSP and the accounting-based measures of CFP, suggesting that in the longer run CSP effects are positive. Most prominent among our results is that fact that by disentangling the ESG Disclosure score into its environmental, social and governance sub-components, we find that a U-shaped relationship exists only between the governance sub-component and CFP. A straightforward implication of our findings suggests that in order for CSR to serve the interests of the shareholders, a long-run planning and considerable resources should be dedicated at this direction, given that CSR expenditure pays off only after a threshold of CSP has been reached. Furthermore, the fact that governance is the key driver affecting the CSP-CFP relationship suggests that CSR investments should be directed to this component.

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1. Introduction

The business case for corporate social responsibility, “a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on voluntary basis” (European Commission, 2001, p.6) is debated extensively in academia and board rooms as a highly relevant topic, particularly in the aftermath of the financial crisis. “In recent years business increasingly has been viewed as a major cause of social, environmental, and economic problems. Companies are widely perceived to be prospering at the expense of the broader community.” (Porter and Kramer, 2011, p.4). Hence, authorities, Non-Governmental Organizations (NGOs) and consumers have called for a more responsible and sustainable way of doing business. However, the decisive question that has to be answered for shareholders in a business context is whether CSR serves a company’s financial performance.

Recent literature appears to be rather inconclusive with respect to the question of whether corporate social responsibility performance (CSP) can be translated in positive corporate financial performance (CFP). While a positive consensus seems to appear (Margolis et al., 2009), yet, this consensus is still fragile, since a range of recent studies support for either negative (Mittal et al., 2008) or mixed results (Schreck, 2011). Most research in this field heavily relies on the dataset provided by Kinder, Lydenberg and Domini (KLD) (see, Inter alia, Andersen and Dejo, 2011; Jiao, 2010; Callan and Thomas, 2009; Brammer et al., 2009; Becchetti and Ciciretti, 2006; Hillman and Keim, 2001; McWilliams and Siegel, 2000). Yet, according to Margolis et al. (2009) alternative measures CSR performance should also be considered in the literature.

Furthermore, most research making use of the KLD dataset only test for a linear relationship between a firm’s corporate social performance and its financial performance. However, recent developments in micro-economic theory rather suggest a non-linear set up (see for instance; Manasakis et al., 2013, 2014; García-Gallego and Georgantzis, 2009). A non-linear relationship between CSP and CFP is therefore in line with economic intuition, but has rarely been tested at all (see, for instance, Barnett and Salomon, 2012, 2006). As in Barnett and Salomon (2012, 2006) we consider that those firms which voluntarily engage in more socially responsible activities incur higher corresponding costs, therefore firms with higher CSP score in the index have invested more financial resources in CSR comparing to those firms with lower CSP.

In addition, measuring corporate social responsibility has proven to be quite difficult since it is a multidimensional concept covering a
whole set of different areas (Waddock and Graves, 1997). Those areas range from stakeholder management issues (such as employees’ working conditions) and environmental concerns up to patronage of arts and culture. As firms tend to use CSR as a means for public relations they often apply a very broad definition of CSR. Hence, alternatives to KLD third-party auditors’ data set need also to be considered in order to assess whether the current results of the literature are robust to different datasets.

Given these gaps in the literature, the main contributions of the present paper can be described succinctly. First, motivated by the works of Barnett and Salomon (2012, 2006), we examine both the linear and non-linear relationship between CSP and CFP, yet under the context of a new dataset, namely Bloomberg’s Environmental Social Governance (ESG) Disclosure score. Bloomberg’s score covers the S&P500 firms for the period 2007–2011 and serves as a proxy for actual CSR performance. The ESG score has the benefit of being easily transformable into a quadratic score. Second, we extend this line of research by disentangling the ESG Disclosure score into its three components so that we can identify the key driver of CFP. In particular, we disentangle the ESG Disclosure score into environmental, social and governance sub-components. Third, this study examines the effects of CSP on CFP using both accounting-based (Return on Assets, Return on Capital) and market-based (Excess Stock Returns) performance indicators, for robustness purposes.

In short, our results of the linear model suggest that there is a negative relationship between CSP and CFP, although this is significant only in the case of the Return on Capital. However, when a non-linear model is used, we find evidence of a U-shaped relationship between CSP and the accounting-based measures of CFP, i.e. Return on Assets and Return on Capital. The results do not allow us to report any significant relationship between CSP on market-based CFP, i.e. Excess Stock Returns. This U-shaped relationship confirms the findings by Barnett and Salomon (2012), who were the first to establish such a relationship by using a normalized version of the KLD dataset. This finding implies that CSR engagement does not pay off immediately, but only after a crucial point of CSR investment is crossed. While in the beginning additional CSR engagement affects profitability negatively, this effect reverses at some point and ultimately serves a company’s profitability.

Most prominent among our findings is the fact that disentangling the ESG score into its sub-components, we find that only governance exhibits a significant U-shaped relationship with CFP. By contrast, no significant relationships can be reported for environmental and social sub-components. This finding has not been previously reported and adds on the discussion regarding the Stakeholder Influence Capacity (SIC) as introduced by Barnett (2007). SIC suggests that stakeholders will only perceive some of the firms as credible CSR actors and therefore reward them for their activities. Our results propose that CSR activities related to improvements in governance will initiate stakeholders’ positive reaction to the firm’s CSR activities. This is in line with a recent strand of the literature that suggests that governance related CSR by firms acts as a credible commitment of firms towards CSR. Therefore, it may boost the positive demand effects from the socially conscious consumers and in turn the financial performance of the firm (see for instance, Lambertini and Tampieri, 2015; Becchetti et al., 2014; Manasakis et al., 2014; Kopel and Brand, 2012).

The remaining of the paper is structured as follows. Section 2 reviews the literature and Section 3 presents the data and the panel regression model. Section 4 analyses the effects of Corporate Social Performance on Corporate Financial Performance, before Section 5 concludes the study.

2. Review of the relevant literature

The theoretical discussion of good corporate citizenship has evolved tremendously since Milton Friedman’s famous and outright rejection of CSR in 1970. He argued that “the social responsibility of business is to increase its profits” (Friedman, 1970, p. 1) and that appointed managers have no right to spend shareholders’ money for other purposes than maximizing shareholder return. In fact, agency theory suggests that insiders, i.e. managers, have incentives to over-invest in CSR to increase their personal reputation (Barnea and Rubin, 2010). This line of thought (shift of focus hypothesis) suggests that increasing CSR expenditure will lead to deteriorating profits as managers are distracted from their main objective.

Yet, the theoretical framework suggested by Friedman is not conclusively supported by theory or by empirical evidence. A lot of convincing arguments have been made of how a good CSR performance as a strategic investment could eventually translate into higher profits and thus higher shareholder value. Jensen (2001) calls this idea “enlightened value maximization” (p. 308) and stresses that a firm’s value development should be regarded as the single criterion to assess the management’s success. Nonetheless, he acknowledges that taking into account different stakeholders interests may be a legitimate and effective means to achieve this objective. This kind of “strategic CSR” is consistent with the strategy chosen by a profit-maximizing firm (Baron, 2001, p. 9). In fact, this idea is an advanced version of the original stakeholder theory as proposed by Freeman (1984). However, strategic investments with respect to CSR have the power to influence the competitive context of a company in a favorable way (Porter and Kramer, 2002, p. 61). Examples of such investments are: managing risk and reputation, human resource management, better access to finance, cost savings due to efficiency improvements and avoiding regulation (see, Reinhardt et al., 2008; Cochran, 2007; Heal, 2005; Greening and Turban, 2000, among others). In line with the above we introduce the assumption of Barnett and Salomon (2012, 2006) considering that firms with higher CSR score in the index have invested more financial resources in CSR compared to those firms with lower CSR.

Given the above, Russo and Fouts (1997) have identified CSR as a source of competitive advantage in accordance with the resource based view of the firm. According to this theory, firms need to possess resources that are valuable, rare, imperfectly imitable and not substitutable in order to create a sustainable competitive advantage (Barney, 1991). McWilliams and Siegel (2011) argue that some of the CSR investments outlined above, namely brand reputation, human capital (including top management) and the easier availability of finance, are exactly such resources and are created by CSR measures. Hence, engaging in corporate social responsibility issues could be a worthwhile consideration for a firm’s management.

Although the body of empirical literature on the CSP–CFP link is vast, it remains inconclusive. There are studies reporting positive, negative as well as neutral relationships between CSP and CFP (Fernández-Feijóo Souto, 2009). More recently a fragile consensus seems to emerge. Recent meta-analysis of 167 studies from 1972 to 2007 conducted by Margolis et al. (2009) suggests that there is a positive effect of CSR on accounting-based as well as market-based profits. However, despite this overall trend, there remains a range of recent literature finding either negative (Mittal et al., 2008) or mixed results (Schreck, 2011). McWilliams et al. (2006) trace inconclusive results back to rather technical causes claiming that diverging empirical results may be due to inconsistencies in the definition of the dependent and independent variables, different samples or poor research design. In fact, many studies rely on similar data and a similar measure of corporate social performance, namely the KLD indicator (Margolis et al., 2009). Apparently, this has consequences for the research design as well and most analysis has been only linear so far.

Baron (2001) argues for better taking into account the kind of CSR a firm engages in. While strategic CSR investments are likely to have a positive impact on profitability, altruistic CSR may have the reverse effect. Hillman and Reim (2001) tested this argument empirically by subdividing corporate social performance into stakeholder management and social issues. This division follows Baron’s (2001) definition of “strategic” and “altruistic” CSR. Regressing those two variables against...
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