



Impact of Corporate Social Responsibility on Firm's Financial Performance

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ABSTRACT

Corporate Social Responsibility has been broadly defined with its different constructs and its significance in the corporate world. This paper puts forward the study of corporate social responsibility and its impact on firm's financial performance with a perspective of Pharmaceutical Industry. All the firms in pharmaceutical industry were observed for their CSR activities and financial performance for Karachi. The statistical tool applied was independent sample t-test to compare the means of two samples which are independent of each other. The results evidently depicts that there is no significant relationship between corporate social responsibility and firm's financial performance.

Key Words: CSR, Financial Performance, Pharmaceutical Industry

JEL Classification: M14, O16

Introduction

It is seen that in organizations managers have an encounter with stakeholders' requirements and demands that are for the purpose to flourish the Corporate Social Responsibility. The CSR is a gist and a push from suppliers, community groups, employees, customers, governments and stockholders – institutional shareholders are an essential element as well (McWilliams & Siegel, 2001). Companies are now assessed on a wider outlook since their motive is not only to cover the financial outcome but also they have to focus on a broader set of societal expectations (Pralhad & Hamel, 1994).

In this study, it has been checked that the importance of CSR in improving financial performance of firms in pharmaceutical industry. This paper have hypothesized that performance and CSR are positively correlated, since many aspects of CSR create a product innovation, a process innovation, or both (McWilliams & Siegel, 2001). The data was taken from the annual reports of companies listed on SEC and State Bank of Pakistan (SBP) for financial information and statement analysis.

The whole work is chased in the following pattern, in next section (2) theoretical background is been discussed with empirical work in the past by different researchers in the concerned area. Later, in section (3) measurement problem is discussed in the local context according to the concepts and definitions of CSR and its activities prevailing in local

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environment followed by Hypothesis section (4) Then is the crux of the paper i.e. methodology of conducting research. Lastly Results, its interpretation, conclusion and implications are given.

Literature Review

CSR are actions witnessed in the social activities, the business environment is surrounded by and it relates to the interests that are not for the organization but is necessitated by the book of law (McWilliams & Siegel, 2001). The basic aspect of CSR is that organizations should be responsible/conscientious for the society as a whole as they are an input and output to the environment.

A known study about CSR by Friedman (1970) study assessed engaging in CSR is an indication that the managers of the organization will be in conflict with the shareholders. Research into this area of relationship between CSR and financial performance has many dimensions within it and has been checked through different aspects. Which include checking CSR in terms of social, environmental and legal aspects.

All these dimensions have been checked using different measurement instrument proposed by different scholars and researchers. Fitch (1976) researched on the environmental aspect of CSR that pollution is hazardous to human life and should be eliminated from all corporate processes. Similarly, in social aspect wise maintaining plants in economically depressed locations, making charitable contributions, promoting community development plans etc are some issues are pointed and discussed by Abbott and Monsen (1979); Anderson and Frankle (1980); Ingram (1978). Preston (1978) used content analysis indexes. Bragdon and Marlin (1972) found a negative relation between social responsibility and financial performance and stated that due to more responsibility of the organization on the society adds on to the additional costs, which is a disadvantage to the firm unlike other firms, which are not responsible. In contrast, other researchers have argued on its positive approach of being directly correlated to each other. Various authors have mentioned in their research studies that customer goodwill and superior employees are important and key to success for corporate social responsibility (Soloman & Hansen, 1985).

In order to know that whether managers are moral and social actors and are accountable for making decisions on the choices they possess about how to meet corporate social responsibilities would require more empirical investigations of how managers actually define and fulfill economic, legal, ethical, and discretionary expectations positioned on their corporations. This helps them know more about how managers consider choices in their organizational and societal environments, the limitations and barriers experienced, and the innovations developed to outwit constraints and put into effect choice. However, the public responsibility, principles of legitimacy and managerial discretion derived from these early works, integrate these ideas into a way of understanding and explaining CSR. The provision of CSR attributes will depend as well on certain characteristics of the market, such as the degree to which firms can differentiate their products and the industry life cycle.

Social Impacts as Outcomes

During the time 1950s and 1970s, scholars and researchers endeavored to define what a corporation's social responsibilities are and are not. Carroll (1979) observed that in the business context the social accountability includes the legal, financial, ethical, and optional expectations that a society contains and organizations at certain time. Frederick (1986) presented the idea as the elementary idea of corporate social responsibility that it is a compulsion on the organization to be societal responsible. Davis (1973) assented that there are other matters further than economic, legal, technical needs of the organization to fulfill

the social benefits along with the conservative monetary expansion, which any organization seek out. In turn the society also expects certain behavior by the organizations through their operations and business-oriented behaviors (Cochran & Wood, 1984).

The other empirical concepts on corporate social Responsibility has been depicted by Clarkson (1988); Hocevar and Bhambri (1989); Randall (1989); Reed, Getz, Collins, Oberman, and Toy (1990); but the concept's hypothetical structure and effect have not worked on more significantly. Miles (1987) provided an important attempt to develop a general theory of corporate social Responsibility by drawing on concepts from strategic management and organization theory to draw out a detailed theory to explain corporate responsiveness.

Performance Measures

There is no clear-cut financial performance measure to see the impact on firm's performance. In fact, there is a wide range of such measures. However, financial performance measures are investor returns and accounting returns. Both have enjoyed periods of popularity, and both have evolved considerably over the course of the past decade. Investor Returns (Cochran & Wood, 1984). Simple returns (change in price per share plus dividends) fail to capture another dimension of vital importance to investors-namely, risk.

The most common measures of accounting returns used in studies of this question are simple price/earnings (P/E) ratios and/or earnings per share (EPS). Bragdon and Marlin (1972); Bowman and Haire (1975); Preston (1978); and Spicer (1978) all used P/E ,EPS, ratios or some algebraic variations as at least one of the measures of financial performance in their studies. In addition, these financial performance measures cannot be accurately compared across firms without considering financial leverage influences and risk differences. The issues are handled by using stock-market-based performance measures. Market returns have several advantages over accounting-based measures: they are (1) less susceptible to differential accounting procedures and managerial manipulation and (2) To produce future economic earnings relatively than past performance is a representation of investors' evaluations of a firm's ability. There are some issues also with stock-market-based performance measures (McGuire, Schneeweis, & Branch, 1986).

This does not mean that one cannot use accounting returns, quite the opposite-accounting returns may be the best proxy for financial performance. However, the particular measures used in previous studies have serious defects (McGuire, Sundgren, & Schneeweiss, 1988).

Social-Financial Performance Link

However, those studies did not control for the possible effects of other variables. Later studies that have attempted to control for differences in risk have offered more careful support for the association among social responsibility and accounting-based performance measures (McGuire, Sundgren, & Schneeweis, 1988).

Although reputational surveys and content analysis of annual reports do provide useful beginning points and other exploratory methods also exist. Also, it is surprising that so much research has been based on the value orientations of a single business critic, and that none of the studies used a financial performance measure, like return on assets that is less susceptible to corporate manipulation (Aupperle, Carroll, & Hatfield, 1985).

Parquet and Eilbirt (1975) pragmatic approach was that corporate social responsibility cannot be scrutinized via profit and loss account.

The Measurement Problem

CSR is varied dimensional concept and consists of behaviors arraying across inputs such as other environmental strategies or investments in pollution control equipment), in-house behaviors or processes (e.g. nature of products produced, treatment of women and minorities, relationships with customers) and outputs (e.g. society relations and benevolent programs) (Waddock & Graves, 1997).

Therefore, after explaining the concept and its constructs briefly, now there is a need to address the research questions on which this whole thesis is going to be based as follows:

- What is the relation between CSR and Financial performance?
- What is the performance of social responsible organization i.e. is over the edge or below the edge performance than the organizations that do not meet the social criteria ?
- What should be the expenditure by an organization on CSR activities?

First question addresses an important issue that is the relation between CSR along with financial performance. Obviously before starting to see the impact of CSR on financial performance within certain sector or business industry one needs to know whether there is any relation between CSR and firm performance. Second question is again of vital importance as Researcher will limit this analysis to Pharmaceutical industry where it was compared to the performance of CSR firms with Non CSR performing firms to see how much it impacts the performance in terms of profitability or profit maximization.

Hypotheses

CSR is a forecaster (predictor) and also a result of firm financial performance as:

Hypothesis 1: Improved financial performance leads to improved better financial CSP, *ceteris paribus*.

Hypothesis 2: Better CSP directs to enhance financial performance, *ceteris paribus*.

As is discussed in the previous section this work will check the relation or association between the CSR and financial performance, whether they are positively correlated or negatively or whether they are directly related or not? Therefore, to answer this question researcher can test the following statements:

- a. CSR and Firms' performance are directly correlated to each other.**
- b. CSR improves firm's financial performance.**
- c. Spending heavily on CSR by a firm has an impact on their performance.**

Research Methods

Data on CSR was obtained from the annual books and magazines of companies and their web sites to see their activities in social sphere. The KSE (Karachi Stock Exchange) listed companies of pharmaceutical industry are the sample of this research, because of the control variables like, size, assets and other requirements are same without biasness. This sample

contains total eight companies which include 5 companies that perform CSR activities and 3 don't.

These companies perform CSR activities including community relation by offering some worthwhile seminars and support to different hospitals by providing free medicines to some small hospital at small towns. Also by opening schools for free or low cost education for poor and potential children who cannot afford at expensive institutions. Whereas, financial data i.e. ROA and ROE of six years was taken from the financial statements of each company which is calculated by using following formulas (Brealey, Myers, & Marcus, fourth edition).

ROA: $\text{NET INCOME} + \text{INTEREST EXPENSE} (1 - \text{TAX RATE}) / \text{AVG TOTAL ASSETS}$

ROE: $\text{NET INCOME} / \text{AVG SHAREHOLDERS' EQUITY}$

The above mentioned framework is for the public oriented organizations as private organizations do have different targets and not related to the marketplace for corporate power and control. Hypotheses have been derived concerning the demand and supply of CSR characteristics across firms, industries and products.

Empirical Analysis

The statistical technique to test the variables t- test for independent samples has been used. The approach of the t- test is to evaluate the real mean difference noticed with the difference expected by probability (Gay & Diehl, 1992).

Table 1:

	CSR	N	MEAN	ST. DEVI
ROA	CSR	30	20.7100	10.64908
	NO CSR	18	17.9056	11.15909
ROE	CSR	30	31.3333	14.61214
	NO CSR	18	33.8778	15.27549

The table above shows the no. of observations taken in each category that is, companies that perform CSR activities and those who do not perform CSR activities. There were 30 observations that performed CSR activities in a year and 18 observations that did not perform CSR activities in the particular year. Then, their mean was taken to see the performance difference of both the categories of companies in terms of their ROA and ROE. The means as can be seen show difference but this difference is not significant enough to be considered.

Similarly standard deviation does not depict considerable variation in the performance of both the categories of companies. But only means and standard deviation was not enough therefore t- test for independent samples were taken to see the difference in mean that whether it is significant difference to accept the hypothesis. To check the normality of data of population that whether it is normally distributed in terms of performance measures, the Shapiro- Wilk test was conducted:

Table 2:

CSR		Shapiro -Wilk		
		Statistic	df	Sig
ROA	NOT CSR	.928	18	.182
	CSR	.947	30	.140
ROE	NOT CSR	.877	18	.023
	CSR	.940	30	.091

Since ROA is normally distributed and ROE is not normally distributed across the sample as indicated by Shapiro test in its significance values. Therefore, the researcher will take RAO only and not ROE in t – test as following:

Table 3:

t- test for equality of means						
		f	Sig	t	df	Sig (2 – tailed)
ROA	Equal variances assumed	.10	.921	.868	46	.390

The t- test (table 3) was conducted by taking equal variance assumption. The equal variance implies that variance in the population behind the samples is equal; if researcher is testing to see the two samples could have come from the same population then the equal variance requirement is automatically met.

The above table (3) shows the t values and their significance. The probability level taken for t- test was 5% that means all the values below 5% are significant while others are not significant enough. All the values in the column sig (2 tailed) that is, significance of t- test are above 5% which means the difference in means are not significant. Therefore based on t- test result ($p > 0.05$) we fail to reject the null hypothesis that CSR does not impact firms' financial performance significantly. Similarly Bowman and Haire (1975);Bragdon and Marlin (1972); found generally positive associations.

Aupperle, Carroll, and Hatfield (1985) used a content analysis of Fortune 500 annual reports performed annually by the accounting firm of Ernst and Ernst and found a negative relationship among corporate social responsibility and accounting-based risk and association among market-based risk and social responsibility were insignificant. This content analysis involves 28 items monitored in the annual reports; the content analysis is then used to construct a Social Involvement Disclosure (SID) scale that Abbott and Monsen (1979) used as a surrogate for corporate social responsibility. They divided 450 firms from the Fortune 500 into high and low groups on the basis of this scale and then examined each group for profitability. They discovered little difference in investment yield between firms in the two groups, even when controlling for size.

Arlow and Gannon (1982) also conclude that research study has not provided strong support for a positive association between profitability and corporate social responsibility. Pharmaceutical sector is an industry where CSR is important in terms of environment and employee satisfaction but least important in terms of social orientation i.e. charitable contributions, educational support of community relations. Therefore, the results are consistent with the need of CSR in this sector that CSR shows positive correlation but does not improve the financial performance significantly.

Conclusion

There has been tremendous work in this area of CSR and financial performance as it has been discussed earlier of different researchers and many of them found the results as it found in this thesis that there is no significant association between the social responsibilities of firms and their performance.

Bragdon and Marlin (1972); Bowman and Haire (1975) found generally positive associations, in contrast, Aupperle, Carroll, and Hatfield (1985) found a negative relationship among corporate social responsibility and accounting-based risk.

Therefore, now the further research into this area should be directed towards improved method for data collection which is reliable and unbiased. For managers, they are responsible for CSR are advised and guided not to spend too heavily on social activities but should also not avoid or ignore expenditure of CSR. As the major reason for success of corporations is its customers, employees and government regulatory bodies which should be satisfied first in order for their existence in the market place.

Therefore, the right way might be to incorporate these activities in companies' activities and expenditures in a way it does not leave firm on economic disadvantage nor does it come under socially Irresponsible Corporation. In short CSR should be performed in a smartly way to avoid both the imbalances of performing and not performing by only achieving its advantages and avoiding its disadvantages.

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