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Corporate Social Responsibility and Its Impact on Financial Performance

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***Abstract*— Due to globalization processes and technological development, companies are receiving more influence on global society than ever. Therefore, business misconduct causes enormous harm to individuals, communities, environments, and stakeholders, whereas ethical behavior is considered to increase the shareholders` value. This confidence has sparked a worldwide call for sustainable, responsible and ethical corporate behavior that gives companies a competitive advantage and greater social and, eventually, economical value. Despite an extensive analysis of the field, there is no consensus in the scientific literature regarding whether corporate social responsibility leads to higher company value in the eyes of financial market participants.**

The main goal of this paper is to examine the impact of a company`s corporate social responsibility on its financial performance. In order to achieve the objective of the research, quantitative analysis is used; in particular the event study method is applied for assessing the financial impact of new information on company's stock price. An event study is employed to examine the relationship between positive and negative statements and changes in a selected stock`s returns on a daily basis, using the concept of abnormal returns as a key measure. The transparency of the events mentioned is ensured using the FTSE4Good Index. The results of the event study are verified by analyzing a portfolio.

Keywords* — *corporate social responsibility, financial performance, stock price

I. Concept of Corporate Social Responsibility

In recent years, society`s expectations for business have increased. In the context of globally high levels of insecurity and poverty, negative reactions to globalization, mistrust for multinational corporations, there is increasing pressure on the business world to deliver not only added financial value to shareholders, but also social value to society at large. Moreover, it should be considered that advances in information technology (e.g. the Internet) lead to quicker exposure of corporate misconducts in any field. In response to these changes, there has been a significant increase in interest for Corporate Social Responsibility (CSR) in the past few decades, and now it represents one of the most important topics for research, receiving academic attention and becoming an important issue for many organizations.

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Corporate social responsibility (CSR) is a concept in business ethics that is getting increasing recognition in the globalised world. Based on a literature analysis, it can be stated that although the concept is widely discussed in theory and practice, it is often intertwined with terms such as corporate sustainability, corporate sustainable development, corporate responsibility etc., and does not have a general definition.

The European Commission is defining CSR as a concept whereby companies voluntarily decide to contribute to a better society and a cleaner environment by integrating social and environmental concerns in their business operation and in their interactions with stakeholders [1].

According to the Organization for Economical Cooperation and Development, CSR is defined as business's contribution to sustainable development [2], which is comparable to the concept of corporate sustainability that calls for the integration of economical and social issues in business management, and in this way a sustainable strategy development and use is ensured in the long term.

In order to contribute to the ongoing discourse in the field, the author suggests defining Corporate Social Responsibility as a concept on the crossing point of legal requirements and social (both stakeholders and shareholders) expectations regarding economic, social, ethical, and environmental matters in a company's strategy contributing to sustainable long term growth and added value (see Fig. 1).

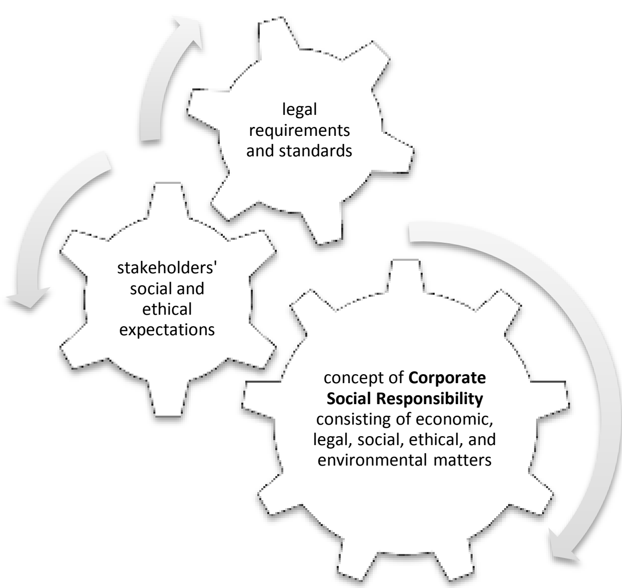

Figure 1. Concept of Corporate Social Responsibility Suggested by Author.

The field of CSR has been growing exponentially. However, there are a few voices claiming that CSR has no place in modern business world, as general adoption of these norms by business would reduce welfare and destabilize the market economy [3]. The following overview sketches out some points of view against CSR, citing researchers in this field; further discussion is available in: *Carroll* [4]; *Ostas* [5]; *Carroll and Buchholtz* [6]; *Smith* [7]; *Fulcher* [8]; *Gallagher* [9]; *Barnett* [10]; *Renneboog et al.* [11]; *Zaharia and Dainora* [12].

- *Legal Obligations* - once a company meets legal requirements, it has satisfied all necessary obligations to society and therefore does not need to undertake any further responsibilities;
- *Lack of Competence* - incompetent efforts to find solutions for social issues waste shareholders' money;
- *Degree of Power of Business* - business is one of the most powerful institutions in society; by giving it decision-making opportunities in the social domain, the problem concerning the balance of power would be exaggerated unnecessarily;
- *Dilution of Primary Purpose* - CSR involves expending limited resources on social issues and in this way decreases the competitive position of a company by unnecessarily increasing its costs.

Despite the widely held idea that social responsibility should begin and end with profit maximization, there is still a place for ethical and social norms in the business world. The following overview consists of a brief summary of the arguments in favor of CSR; further discussion is available in: *Villiers and van Staden* [13]; *Roberts and Dowling* [14]; *Jenkins* [15]; *Brammer et al.* [16]; *Schaper and Savery* [17]; *Okpara and Idowu* [18]; *Windsor* [19].

- *Viability of Business* – society has granted incredible power and freedom to corporations with the expectation that they would use that power to effectively serve society`s needs;
- *Interest of Business* – CSR as a tool to attract, motivate, and retain talented workforce, attract customers, improve reputation, and diminish costs through environmental initiatives;
- *Business Resources* - business has valuable resources such as management, practical know-how and capital that could be used to solve social problems;
- *Avoidance of Government Regulations* - through fulfillment of social responsibility norms companies could possibly avoid strict attention from the regulatory institutions.

Each representative of the business world can evaluate the above-mentioned arguments and make his or her own decisions about including CSR in the business strategy.

Being aware of the strong negative view on the CSR concept it is necessary to underline that one of the most important argument supporting CSR is that such actions can improve company`s performance, that should be discussed into greater details in the coming part of the article.

II. Relationship between CSR and Financial Performance

Some researchers believe that CSR can improve the competitiveness of a company in the long run, although this assumption is conditional on a positive relationship between CSR and a company`s financial success (the examples could be found in *Weber* [20]). Therefore, one of the theory's key aspects is the relationship between CSR and financial performance, which also happens to be the most problematic area of CSR theory (examples in *Angelidis et al.* [21]). While some researchers point in favor of a positive relationship (examples in *Orlizky et al.* [22]; *Sweeney and Coughlan* [23]), others argue that this connection has not been fully established (examples in *Park and Lee* [24]) and the mechanism through which financial performance is enhanced by CSR is not well understood and described (examples in *Doh et al.* [25]).

Looking on this problem from the investor's point of view, it can be mentioned that investors have access to public information about a company's CSR, which is presented in news, sustainability reports, and indexes such as the *FTSE4Good Index*. Therefore, one can assume that this information should be also reflected in the share price of any publically traded company. Regarding the index mentioned above, one can notice that companies included in this index are monitored and a kind of rating is available. For companies to be a part of this index means that they are obliged to develop and to follow economical, environmental and also social standards in their everyday operations. They are required to communicate through sustainability reports and disclose their behavior, providing information regarding their actions in order to meet the expectations of stakeholders and shareholders, which could result in an improvement of financial and economic performance [26].

Extensive literature analysis leads to the conclusion that the relationship between CSR and financial performance could be investigated through both theoretical and empirical studies, while empirical research could be divided into qualitative and quantitative research. Qualitative research is linked to the use of case studies or best practices in order to analyze the relationship between CSR and competitiveness and/or financial success; quantitative empirical research is based on data analysis using three different approaches: multiple regression studies, event studies and portfolio studies. Further discussion can be found in *Weber* [27].

The main goal of the present paper is to examine the impact of a company`s corporate social responsibility practice on its financial performance. In order to achieve the objective of the research, quantitative analysis is used; in particular, the event methodology assesses the financial impact of new information on a company's stock price. It examines the relationship between positive and negative statements and changes in a selected stock`s returns on a daily basis, using the concept of abnormal returns. The transparency of the events mentioned is provided by the *FTSE4Good Index*. The results of the event study are verified using portfolio study.

Event studies are used for recognition of abnormal returns around the date of the publication of a certain statement. A company stock price will decrease in the case of some bad news and increase when the news is good. The effect may persist for several days depending of the strength of the event. The concept of abnormal returns is described in several papers e.g. in *Cheung* [28], *Oberndorfer et al.* [29], etc. The following part is an overview of the main aspects necessary for an understanding of the methodological concept of the research that follows.

Abnormal returns represent returns earned after adjusting for normal returns; in other words, the rate of return $R_{abnormal}$ is adjusted by subtracting the expected return $R_{expected}$ (2) from the actual return R_{actual} (1), where P is stock price, α is mean return over the period not explained by the market, β is sensitivity to the market risks, R_{Market} represents return on a market index, and ε denotes statistical error.

$$R_{actual} = \frac{(P_t - P_{t-1})}{P_{t-1}} \quad (1)$$

$$R_{\text{expected}} = \alpha + \beta * R_{Market} + \varepsilon \quad (2)$$

A. *Research Methodology*

At the first stage, it is necessary to define the event studies of interest. In the present paper, an event was defined as a company`s inclusion in the *FTSE4Good Index* – any company listed in this index has to satisfy particular economical, social and environmental standards.

At the second stage, it is essential to identify the period over which the stock price is examined, also known as the event window. The event window was set to 2 months (which is similar to the general practice in a kind of research) –1 month preceding the actual event and 1 month following the event were considered.

At the third stage, abnormal returns along the period of event window are calculated, and significance of the results is checked.

In order to confirm the significance of the results and verify conclusions, a portfolio study supplements event study (as an additional tool in the framework of quantitative empirical research). The hypothesis of the second study was formulated as follows: inclusion in the index would represent a company's CSR and increase its value in the eyes of investors regardless of the economic cycle and the company`s financial results and future expectations, leading to outperformance of the investment portfolio.

B. *Result of Studies*

As it was already mentioned, the *FTSE4Good Index* was chosen as a benchmark of a company`s CSR in the global framework. In order to keep consistency in research, regional diversification was eliminated and only companies with a domicile in German were analyzed. The period studied covered four years from 2010 (after the recent financial and economic crisis, when there was particularly demand for social standards by society, politics and some business representatives) till 2013.

Figure 2 presents the development of *FTSE4Good Index* during the specified period, while changes of the index (of importance for the present study) were the following – inclusion of the following companies (represented with their ticker): GE1, HNR1; HOT, LIN (September 2013); SIE (March 2012); LXS (March 2011); CLS1 (September 2010) and SWVK (March 2010).

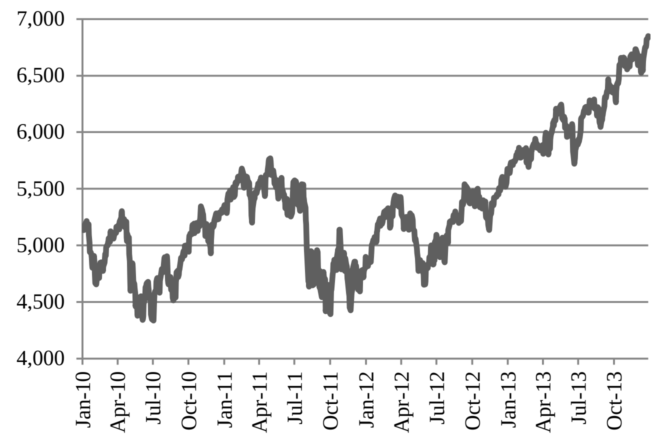

Figure 2. FTSE4Good Index (January 2010 – December 2013). Data Source: Bloomberg

Inclusion in the index could be considered as important event helping maximize a company`s value in the long run and contributing to its good reputation. It was assumed that such an event would have a positive impact on the stock price, so that a positive relationship between CSR and performance would be established in a calculation of abnormal return as the difference between actual return and expected return (using the FTSE Germany Index as a benchmark).

The calculations show that, for each of the events (regardless the particular company) taking place in the different event windows, none of abnormal returns ($R_{abnormal}$) were significantly different from zero, even though a slight positive or negative difference was noticed in the days following an event that could be attributed to factors other than CSR that influenced investors` decisions. The hypothesis that CSR, represented as inclusion in the index, has a positive impact on a company`s stock performance was not confirmed.

Regardless of unsatisfactory results in the first part of the empirical study, a hypothetical investment portfolio of equally weighted stocks was constructed. The main portfolio characteristics were the following:

- *Number of companies:* 8 starting from 23/09/2013 (stocks were acquired as soon as they were included in index);

- *Geographical allocation:* 100% Germany (Benchmark: *FTSE Germany Index*);
- *Instruments:* 100% stocks (further restrictions: no short sale, 100% investment);
- *Sector allocation:* financials (29.21%), health care (4.30%), industrials (26.59%), information technology (6.03%), materials (33.84%).

Analysis of the portfolio`s performance indicates that, even though investment in companies that exhibit CSR could take place and result in some profit, they do not outperform the market as a result, i.e. potential investors do not consider fulfillment of CSR requirements set by the FTSE as being enough to increase company`s attractiveness in the investment process.

Figure 3 presents test portfolio performance (white line) vs. benchmark (yellow line) in the upper graph and performance difference in the graph below.

Figure 3. Portfolio Performance vs. Benchmark (March 2010 – December 2013). Data Source: Bloomberg. Own calculations.

A closer look at statistical characteristics of the portfolio is provided in Table 1.

TABLE I. RISK AND RETURN MEASURES (TEST PORTFOLIO (TP) VS. BENCHMARK (B))

	6 months		1 year		2 years	
	TP	B	TP	B	TP	B
Total Return	5.67	16.46	8.58	27.16	15.09	40.97
Stand. Dev.	12.77	14.43	15.04	16.81	18.17	19.31
Sharpe Ratio	1.34	3.72	0.87	2.47	0.64	1.5
Jensen Alpha	-23.4	-	-18.68	-	-12.31	-
Inform. Ratio	-3.15	-	-2.3	-	-1.44	-
Treynor Ratio	0.23	-	0.17	-	0.14	-

III. Conclusions

The field of CSR has been growing exponentially in the past few years. However, there are a few voices claiming that CSR has no place in the modern business world, while others consider that there is still a place for ethical and social norms in business. Looking at this problem from the investor's point of view, it can be mentioned that investors have access to public information about company's CSR, which is presented in news, sustainability reports, and indexes. Therefore, one can assume that, this information should be also reflected in the share price of the publically traded company.

One of the hypotheses tested in the present paper was formulated as following: inclusion in the CSR index could be considered an important event helping to increase stock's price in the short run. The calculations provided have shown that, for each of the studied events taking place in different event windows, none of abnormal returns were significantly different from zero, so that the hypothesis about positive impact of CSR expressed through inclusion in the index on the company`s stock performance was no proven. Further analysis of portfolio`s performance has shown that even though investment in companies that exhibit CSR could have a positive result, it does not outperform the market, so that potential investors do not consider fulfilment of CSR requirements as being enough to increase a company`s attractiveness.

Such a failure could be explained from different points of view, necessitating further research. Meanwhile, it should be noted that participation in the FTSE4Good Index does not equal being a promising company in the eyes of financial market participants, i.e. CSR is not a reason for making financial decisions. As a result, one can come to the conclusion that the role of CSR at its current stage of development is somewhat overvalued.

What could be a possible solution: increased credibility of the CSR index would probably have positive impact on the value of the company, if compliance with CSR standards is not limited to policies description and issuances of reports. Another solution could be bigger support from the side of the government for CSR companies, but are the taxpayers really interested in "such an extra"?

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About Author:

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