Does corporate social responsibility affect companies’ financial performance? A review of empirical studies

The increasing changes in environmental, social and economic trends have encouraged companies to be more involved in socially responsible initiatives. Corporate social responsibility (CSR) is the involvement of a company in addressing environmental and social challenges faced by the society. Whilst the main objective of a company is wealth creation and profit maximisation, concerns for contribution to societal development have mooted useful and mutual beneficial business practices with potential financial involvement. The study reviewed and examined CSR theories to locate the impact of these theories on a company’s financial performance. The review and examination of the studies conducted from the 1970s to 2013 found a mixed pattern of the relationship between financial performance and CSR. This mixed pattern provides evidence that the relationship between companies’ financial performance and social performance could be positive, negative or non-significant. This mixed pattern is part of the big ongoing debate on this topic, and such a debate is possibly inevitable, given that empirical studies test different hypotheses, use different methodologies and consider different sectors or industries at different time periods.

Introduction

Increasing changes in environmental, social and economic trends have encouraged companies to be more involved in socially responsible initiatives, known as corporate social responsibility (CSR). CSR is broadly defined as ‘a company’s positive impact on society and the environment through its operations, products and services and through its interactions with key stakeholders such as employees, customers, investors, communities and suppliers’ (Katsoulakos & Katsoulakos 2006:13). Several terms such as corporate citizenship, corporate accountability, business ethics, corporate social investment (CSI) and corporate responsibility have been used interchangeably with CSR (Amaladoss & Manohar 2013). CSR is therefore associated with different definitions, but such definitions commonly refer the role of companies in integrating social, economic and environmental dimensions to fulfil the needs of all its stakeholders (Barthorpe 2010). Thus, CSR explains how companies direct their activities towards creating value for people (creation of well-being inside and outside the organisation), planet (achievement of ecological quality) and profit (maximisation of profit), whilst communicating with all stakeholders on the basis of transparency (Carroll 1999). With the help of CSR, companies are able to address various challenges faced by the society in which they operate.

The involvement in CSR means that companies have to channel some resources towards developing strategies that seek to improve their involvement in CSR. Thus, CSR encourages companies to add the social welfare role to their major objective of value maximisation. This role has raised a number of questions, including why should companies be involved in CSR and whether CSR has any effect on companies’ financial performance (Renneboog, Horst & Zhang 2008). To address these questions, a number of theories that seek to explain the motive behind CSR and its contribution to a companies’ performance have been developed. Some theories (Freeman 1999; Freeman & McVea 2001) suggested that a company should benefit from improved CSR, whilst others (Friedman 1970) considered the involvement in CSR as a deviation from a company’s core objective of making profit. Thus, this paper aims at reviewing empirical studies on the relationship between companies’ social performance and financial performance to establish whether the findings support the notion that companies benefit financially from their involvement in CSR.

Theoretical approaches of CSR

There are a number of theories that explain the motive behind companies’ involvement in CSR, but they are classified into two major categories, namely value maximisation and stakeholder approaches. These two approaches mostly differ when it comes to the process of maximising a
company’s value and the motive behind socially responsible activities, but they agree that the long-run value of a company should be maximised.

Shareholders value maximisation approach

Shareholders value-maximisation approach involves a group of theories with a common view that all companies’ decisions should seek to increase the total long-run market value of the firm (Jensen 2002), which implies that the decision of a company’s involvement in CSR should be aligned with value maximisation. Thus, the sole purpose of CSR should be creating wealth for its shareholders through value maximisation (Garriga & Melé 2004). In this approach, the value to be maximised is the market value, which may be different from profit maximisation (Jensen 2002). However, in the context of CSR, the terms value maximisation and profit maximisation or wealth maximisation are often used interchangeably. In the context of the study, the value-maximisation approach refers to any theory that links CSR to a single objective of maximising company value or profit.

Most of the theories under the value-maximisation approach have their origin in neoclassical economics; hence, these theories are described as utilitarian or traditional. The term utilitarian mainly refers to the traditional economic approach of studying a company’s behaviour solely based on its profit-maximising function (Secchi 2007), which means that companies should primarily be concerned with shareholders’ utility maximisation (Melé 2006). Milton Friedman (1970) is one of the economists who represented this stream of thought in his article published in New York Times Magazine that the sole social responsibility of a company is to increase its profits. Friedman argued that a company’s involvement in social responsibility should be motivated by a single objective of profit maximisation; otherwise, the involvement in CSR would only create additional costs to the company. Friedman also argued that a company’s shareholders should be involved in the socially responsible activities as individuals instead of being involved through the company.

These traditional theories recognise that a company is socially created and approved, but insist that a company’s primary objective is to provide goods and services to the society at the right price with good quality (Knox & Maklan 2004). As a result, companies achieve the role of social responsibility by focusing on achieving economic objectives through social activities that generate profit (Garriga & Melé 2004). Proponents of this group of theories maintain that if shareholders’ wealth is maximised, social welfare is also maximised, and as a result a company’s social responsibilities should only be challenged based on the ability of maximising its shareholders’ wealth (Margolis & Walsh 2003). According to this stream of thoughts, a company’s social responsibility depends on its financial performance, which implies that social performance and financial performance are positively related across a wide range of industries (Orlitzky, Schmidt & Rynes 2003). Hence, companies should focus on a single goal of maximising shareholders’ value, and social performance will be achieved through this value-maximisation goal. Generally, this group of theories indicates that social welfare is maximised when all companies in an economy maximise their total wealth or value.

Stakeholder approach

The second group of theories that explain the motive behind companies’ involvement in socially responsible activities is described as stakeholder approach. This approach seeks to explain the interaction between a company and its immediate society. Contrary to the value-maximisation approach, the stakeholder approach argues that companies should take into consideration all their constituencies known as stakeholders (Jensen 2002). The stakeholder approach goes beyond the neoclassical view of treating a company as a closed system and views a company as an open system that should manage its relations with society (Steurer et al. 2005). The stakeholder approach became a central point in the mid-1980s, especially after R. Edward Freeman’s stakeholder approach to strategic management in 1984 (Freeman & McVea 2001). Freeman suggested that companies have to pay attention to their relationship with all stakeholders (individuals or groups who can directly/indirectly affect or be affected by a company’s activities) to be effective in the society. The proponents of this approach argue that, in a competitive environment, a company may not survive without support from all its stakeholders (Freeman 2010), meaning that companies should interact well with all their stakeholders to secure important resources provided by such stakeholders (Steurer et al. 2005). Maintaining a good relationship with all stakeholders can be a source of competitive advantage because such stakeholders have resources and power to influence a company’s survival, competitiveness and profitability (Good 2002). Thus, a company does not exist only to earn profit but also to satisfy the interest of all its stakeholders (Ihugba 2012). Whilst this view is contrary to the view of the value-maximisation approach that a company maximises its profits to a single stakeholder group, the shareholders, the stakeholder approach proposes inclusive strategies of integrating the interests of all stakeholders, rather than maximising the interests of one group of stakeholders.

Although the stakeholder approach advocates for equal treatment of all stakeholders, it emphasises that stakeholders have different levels of influence on a company’s activities. Hence, this approach encourages companies to develop strategies inclusive of all categories of a company’s stakeholders. However, this may not be a simple task, as there may be a conflict of interest amongst stakeholders’ categories. In other words, each group of stakeholders has its own interest, and it may be difficult to defend all stakeholders’ interests. Because of the potential conflicts amongst stakeholders, the stakeholder approach encourages companies to evaluate the demands of the different stakeholders’ groups and to make them match with the company’s objectives (Good 2002). Thus, a company has to take into consideration the economic,
environmental and social concerns of all stakeholders, to
develop inclusive objectives supported by every member
of the society (Freeman & McVea 2001), and this approach
suggests that all stakeholders, who voluntarily come together
and cooperate to improve everyone’s condition, can still
create an economic value for the company.

Empirical findings on the relationship between CSR and
corporate financial performance

This paper has reviewed the empirical studies conducted
from the 1970s to 2013 on the relationship between companies’
social performance and corporate financial performance
(CFP). A summary of these studies with their empirical
findings, given in Table 1, shows that empirical studies on
this topic have produced different findings, suggesting that
there is no consensus on the relationship between CSR and a
company’s financial performances. Some studies concluded
that CSR has a positive effect on a company’s economic
performance, whilst others found that CSR negatively
affected companies’ financial performance. In contrast, a
number of studies produced inconclusive results or found
that CSR has no effect on a company’s financial performance.

Methodological differences in measuring CFP

Table 1 shows that the reviewed empirical studies on the
relationships between CSR and CFP from the 1970s to
2013 mostly used accounting- or market-based measures
of CFP, with the exception of a few studies that used
survey questionnaires. These two common measures of
CFP, accounting- and market-based measures, tend to
have a significant impact on the findings (Peloza 2009). For
example, a company’s social performance tends to correlate
more with accounting-based measures (such as return on
equity) than with market-based measures (such as share
returns) of financial performance (Orlitzky et al. 2003). These
two measures have their weaknesses and strengths. On the
one hand, accounting measures capture only the historical
aspects of a firm’s performance and tend to be subject to bias
from managerial manipulation and differences in accounting
procedures (Tsoutsoura 2004). On the other hand, market-
based measures of CFP can be affected by other factors such
as speculation (López, Garcia & Rodríguez 2007). However,
market-based measures represent the investor’s evaluation
of a company’s ability to generate future economic return
(McGuire, Sundgren & Schneeweis 1988), and hence it
appears to be less vulnerable than accounting procedures
(Tsoutsoura 2004).

Another way of categorising the methodology used by
empirical studies on the relationship between CSR and CFP
is to focus on the short- and long-run measures of CFP. This
reveals that two types of methodology were used by the
reviewed studies. The first one is the event study methodology,
which mostly examines the short-term effect of CSR on CFP
based on market measures of financial performance. This
review of empirical studies shows that studies that used
event study methodology produced different results. Some
studies found a positive or a negative relationship, whilst

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others reported a non-significant relationship. The second type of methodology used was a regression and correlation analysis, which mostly estimated the relationship between CSR and CFP based on accounting measures of CFP, such as return on equity and return on asset. Similarly, these studies also produced mixed results. Although these studies tend to suggest that both methodologies produced similar (mixed) results, there is still a big academic debate on the type of methodology to be used in assessing the effect of CSR on CFP.

Empirical evidence supporting a positive relationship between CSR and CFP

Theoretical explanations behind a positive relationship between CFP and CSR are based on the view that socially responsible companies have an economic advantage. Proponents of this view reason that socially responsible activities increase CFP by improving companies’ brand image and reputation, employee morale and productivity, and customer satisfaction (McGuire et al., 1988), which implies that there are both theoretical and empirical explanations behind the positive relationship between CSR and CFP. A study by Ullman (1985) reviewed 13 studies that conducted empirical investigations on the relationship between financial performance and social performance of US companies. Out of these 13 studies, 9 reported a significant relationship between the variables, and within these 9 studies, only 1 study found a negative relationship, whilst the remaining 8 reported a positive relationship between financial performance and social performance. Overall, Ullman’s (1985) findings suggested that there appeared to be a positive relationship between social and financial performances, which implies that socially responsible companies tend to outperform less socially responsible companies (Ullman 1985). The results are supported by other studies (Hossain et al. 2013; Lin et al. 2009; Loureiro, Sardinha & Reijnders 2012; Luo & Bhattacharyya 2006; McGuire et al. 1988; Ruf et al. 2001; Tsai et al. 2010; Tsoutsoura 2004; Wahba 2008), which found a positive relationship between CSP and CFP.

Ruf et al. (2001) investigated the relationship between CSR and accounting measures (return on sales and return on equity) on a company’s financial performance, which showed that improvements in CSR have both short- and long-term effects on CFP. This was confirmed by Tsoutsoura (2004) who tested the relationship between companies’ social responsibility and financial performance in 500 US companies over a period of 5 years (1996–2000). Furthermore, Lin et al. (2009) conducted a similar investigation, but their focus was on 1000 Taiwanese companies during the period 2002–2004, and their findings confirmed a positive relationship between CFP and CSR. However, they found that the relationship tended to be strong in the short-term, with mixed results for long-term analysis.

A study by Loureiro et al. (2012) focused on investigating the contribution to consumer satisfaction of the perceived socially responsible activities in terms of labour practices, community development and environmental performance in the Portuguese automobile industry. The study concluded that companies’ socially responsible activities contribute to better financial performance by directly reducing costs and increasing productivity and by indirectly increasing customer satisfaction (Loureiro et al. 2012). The results are similar to the findings by Jiao (2010) who measured the extent to which companies meet the expectation of its stakeholders (such as employees, customers, communities and environment). Jiao’s (2010) results showed that stakeholders’ welfare represented intangible benefits. More specifically, stakeholders tend to associate employees’ welfare and environmental performance with intangible value such as reputation or human capital. Other studies (Hossain et al. 2013; Luo & Bhattacharyya 2006; Tsai et al. 2010) have also confirmed that socially responsible activities play a crucial role in improving a company’s brand image, reputation and customer satisfaction and eventually improve financial performance.

Empirical evidence supporting a negative relationship between CSR and CFP

Expected negative relationship between CFP and CSR is based on the view that there is a trade-off between companies’ financial performance and CSR. Advocates of this view propose that socially responsible companies tend to be at a competitive disadvantage because of the costs added by their involvement in socially responsible activities (Alexander & Buchholz 1978). This view of a negative relationship between CFP and CSR has been supported by empirical findings from different studies (Abiodun 2012; Lerner & Fryxell 1988; López et al. 2007; Wright & Ferris 1997). Lerner and Fryxell (1988) used a multidimensional approach to examine the effect of CSR on CSF, and their results showed that the social determinants of CFP tend to vary with the dimensions of CSR. In other words, the relationship between CSR and CFP
seems to be affected by adopted measures of CFP. Lerner and Fryxell (1988) concluded that there was a negative relationship between CSR and CFP. Using an event study methodology, Wright and Ferris (1997) investigated how US companies were affected by their socially responsible decision of removing their investment from South Africa from January 1984 to December 1990, and their results showed that this decision of divestment had a significant negative effect on the particular company’s excess returns.

A study by Janney, Dess and Forlani (2009) used an event study method to investigate market reactions to commitment to a better social performance for European and US multinational companies and found a negative market reaction to CSR in US-based companies. Similarly, a study by Abiodun (2012) on 10 Nigerian companies during the period 1999–2008 found a negative relationship between companies’ profitability and their investment in initiatives perceived to be of social responsibility. Higher profit margins were recorded for companies with less socially responsible activities. This was also confirmed by López et al. (2007) who used a bigger sample (110 companies) than Abiodun (2012) and obtained similar results. Findings from López et al. (2007) showed that there is a significant short-term negative relationship between companies’ profitability and their investment in CSR. The negative relationship between CSR and CFP has therefore been empirically proved.

Non-significant and inclusive results on the relationship between CSR and CFP

An earlier study by Alexander and Buchholz (1978) used risk-adjusted market return to investigate the relationship between the stock market performance of a company and social responsibility. This study concluded that there was no significant relationship between the degree of social responsibility and stock market performance. Furthermore, there was no significant relationship between a company’s social responsibility and its level of risk. Similar results were obtained from other earlier studies (Abbott & Monsen 1979; Aupperle, Carroll & Hatfield 1985; Chen & Metcalf 1980), which did not find any significant relationship between CSR and CFP. For example, Aupperle et al. (1985) concluded that there was no significant relationship between a company’s socially responsible activities and its profitability, even when both accounting- and market-based measures were considered.

Studies conducted during the 1990s (Griffin & Mahon 1997; Roman, Hayibor & Agle 1999; Wood & Jones 1995) mostly focused on the review of findings from previous studies. Wood and Jones (1995) reviewed empirical studies on the correlation between CFP and CSR, and their conclusions showed that the relationship between CSR and CFP was still ambiguous because causality between CSR and CFP tended to be complex. Griffin and Mahon (1997) reviewed 51 empirical studies and categorised them into three categories (negative effect, positive effect and no effect or inconclusive) based on their findings, and their results showed that out of 51 studies, 9 found no relationship between CSR and CFP or the results were inconclusive. However, their review had limitations as their findings disregarded methodological considerations of the studies under investigation, even if the methodology seemed to have an effect on the results.

The issue of methodological limitation was addressed by Roman et al. (1999) who modified and extended Griffin and Mahon’s (1997) review by analysing the suitability of the methodology and measurement of CFP used by each study. Roman et al. (1999) reviewed 54 empirical studies, on the same topic, for the period of 25 years from the 1970s to 1997, and the findings showed that 14 out of 54 studies (approximately 26%) produced inconclusive results or found no significant effect between CSR and CFP, which confirms the inconsistent nature of findings on the effect of CSR on CFP. McWilliams and Siegel (2000) insisted that this inconsistency in results pertaining to the relationship between CSR and CFP was because of the flawed empirical analysis. They argued that the studies that used the model that excluded factors such as research and development (R&D) and advertising intensities was misspecified and would produce biased results, which emphasises that the contribution of methodological differences to the inconsistent results on the relationship between CSR and CFP cannot be ignored.

In addition to the studies that produced inconclusive or non-significant results on the relationship between CSP and CFP, there are studies (Inoue & Lee 2011; Kang, Lee & Huh 2010; Peloza 2009; Renneboog et al. 2008) that produced mixed results on this topic. A study by Kang et al. (2010) used two different dimensions for measuring financial performance, namely accounting profitability and market value, to examine the effect of CSR activities on financial performance value across four industries (hotel, casino, restaurant and airline companies) of the hospitality sector in the USA from 1991–2007. Findings of this study showed mixed results across different industries, and these results tended to change with the method of measurement used. CSR was found to have a significant positivity effect on CFP in the hotel industry and a negative effect in the airline industry. However, Kang et al. (2010) found no significant relationship between CSR and CFP in the casino industry. The findings, therefore, suggested that the relationship between CSR and CFP tends to vary with the industry, supporting the use of a model (by McWilliams & Siegel 2000) that controls the industry factor.

Inoue and Lee (2011) conducted a similar study amongst companies within four tourism-related industries (airline, casino, hotel and restaurant), in which they divided CSR into five dimensions (employee relations, product quality, community relations, environmental issues and diversity issues) and tested the effect of each dimension on CSR. Companies’ voluntary activities for community were found to have a significant negative effect on short-term profitability for the airline industry and a significant positive effect on
both short- and long-term profitability for the hotel and restaurant industries (Inoue & Lee 2011). Overall, Inoue and Lee’s (2011) findings suggested that CSR dimensions such as diversity issues, employee relations, environment concerns and product dimension had a different effect on CFP, and such effects tended to vary across the four tourism-related industries. Moreover, the findings suggested that these dimensions of CSR affect short- and long-term measures of CFP differently.

Conclusion and recommendations

The review of empirical studies, from the 1970s to 2013, has shown that the relationship between CSR and CFP is inconsistent and that this inconsistency may sometimes be associated with the measures used to ascertain a company’s financial performance. Some studies used profit maximisation as an indicator of a company’s financial performance, which was reflected by accounting measures, whilst others focused on value maximisation, which is mostly related to the market value reflected by a company’s share price. Hence, this may explain the inconsistent results on the relationship between CSR and CFP, as maximisation of a company’s value is not always the same as profit maximisation. On the one hand, a large number of reviewed empirical studies supported a positive relationship, implying that the market tends to react positively to a company’s involvement in CSR. These findings support the stakeholder approach which suggests that a company should benefit from meeting the demands of all its stakeholders. On the other hand, the existence of a negative relationship or inconclusive results between CSR and CFP suggests that there is no empirical consensus on the link between CSR and CFP. Hence, reviewed empirical studies confirmed the inconsistent results on the relationship between CSR and CFP. This inconsistency is the big ongoing debate on this topic, and it is possibly inevitable, given that the empirical studies test different hypotheses, use different methodologies and consider different sectors or industries at different time periods.

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Competing interests

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