Impact of Corporate Social Reporting on Financial Performance of Firms

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Abstract

This paper aims to study if there is an impact of corporate social reporting on financial performance of firms. Corporate social reporting refers to the disclosures made by a firm regarding its engagement with society and impact of its activities on society. Financial performance in this study is represented by both market-based and accounting ratios. This study is a quantitative study based upon positivist paradigm. Substantial literature review is conducted to frame theoretical framework. Based upon that framework workable hypothesis are proposed. Data is collected from secondary sources and tested empirically using statistical tools and techniques. The results indicate that there is significant relationship between corporate social reporting and market based measure while no significant impact is reported for accounting based ratio.

Keywords:

Corporate Social Reporting, Tobin's Q, Corporate Governance, Return on Assets

1. Introduction

Corporate governance is known to impact financial performance of firms. How individual governance mechanism influence firm performance has been a subject of research in both developed and developing economies. Corporate reporting is an internal and explicit governance mechanism that is critical in assessing firm value in the market. Corporate reporting also referred as "Transparency & Disclosures" of business activities is one of the most focused corporate governance mechanism around the world today. Investors, government and society are demanding ever increasing number of disclosures on firm's activities. Firms are now required to incorporate environmental, social and governance (ESG) indicators in their disclosures. Typically, they are required to disclose against the following parameters (i) ownership structure & shareholder rights (ii) financial and operational information (iii) board and management structure and process and (iv) business ethics and corporate responsibility. While some disclosures are mandatory others are voluntary in nature. Higher and detailed disclosures imply better governance.

Friedman (2007) asserted that only singular goal of a firm is to maximize returns for its shareholders. This argument is in line with shareholder theory where the only goal of the firm is to maximize the returns for its shareholders. However alternative argument is line with the stakeholder theory that proposes that interests of all other stakeholders should be balanced while arriving at the returns of the shareholders. It implies that the returns to the shareholders should not be

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arrived at by compromising with the interests of other stakeholders since it is a threat for long term business sustainability. It is in this spirit that CSR reporting is gaining momentum in the corporate world today and socially responsible businesses are rated higher than their other counterparts. It is viewed that being socially responsible reduces the firm's risk exposure and there is less explicit cost.

Socially responsible businesses have three fold targets-economic, social and environmental performance and treat shareholders at par with other stakeholders. This three-fold target may however have positive or negative impact on shareholders' interests. Integration of third party interest may result into underperformance of share price and may sub-optimize shareholder interests. The positive impact could be that firm may be able to reduce long-term financial risk that may arise due ignoring interests of other parties and which may later result into explicit costs. Hence the subject has received attention from researchers to discover the impact of social reporting on firm performance. Relationship between CSR reporting practices and firm performance has been reported in the prior research.

2. Literature Review

Prior studies provide inconclusive evidence. Margolis and Walsh (2001) in their meta-analysis study on CSR reporting and firm performance identified fifty-five percent of the studies that found positive relationship, twenty-two percent studies reported no relationship, eighteen percent found mixed relationships and four percent reported negative relationship.

Stakeholder theory is based on the premise that a firm is not only responsible to its shareholders but also other stakeholders who affect the firm and get affected by the firm activities. Corporate Social Responsibility (CSR) reporting is an important aspect of corporate reporting practices according to the stakeholder theory. Stakeholder theory considers shareholders as one among the other stakeholders. The important tenet of this theory is maximization of overall human welfare (Bhasa 2004). The results of the firm are arrived at not at the cost of other stakeholders but by balancing the interests of all the stakeholders. The needs of shareholders are met only by satisfying the needs of all the stakeholders (Jamali 2008). It is the duty of directors to see that there is balance of interest among stakeholders (Baxt, Ramsay & Stapledon 2002, 166). There is much debate on whether the directors' responsibilities extend beyond maximizing shareholder value. Varying views exist regarding this debate.

Friedman (1970) asserts that the managers are agents of the shareholders or the real owners of the firm who manage firm on their behalf and have no right to expropriate their wealth for fulfilling the interests of other parties. However Freeman (1984) presents a contrasting view by asserting that management's decisions should extend to wider spectrum of stakeholders positively.

Freeman (1984); McGuire et al. (1988) in the modern stakeholder theory discusses how value of firm is related to the cost of explicit and implicit claims. They asserted that if implicit contracts are not honored by the firm, then a firm might have to meet the costs of explicit claims by the parties to the contract which might be costly. It can be said that firms practicing and reporting CSR may have to face lower explicit claims.

Various stakeholders to the firm are customers, employees, suppliers, society and government. A firm that is perceived as having high CSR image, as cited by McGuire et al. (1988), may have to face lower labour problems and would have higher customer retention and loyalty, long term supplier relation and positive image in society. CSR influences banks and other institutional investors' investment decisions (Pava & Krausz 1996). Hence it can be said that CSR in a firm may facilitate its access to capital.

Frooman (1997) in a meta-analysis found that the firms engaged in socially irresponsible & illicit behaviour had lower market valuations in the long run. Johnson (2003) also noted that investors punish those firms that are engaged in illegal and irresponsible acts. But he did not find evidence to the fact that firms that perform beyond legal and community standards were rewarded by the investors. Balabanis et al. (1998) stated that high investment in socially responsible activities result into additional costs.

The recent literature on the subject has considered both accounting based and market based measures of firm performance. While accounting based measure such as ROA is used to assess the operating performance based on shareholder's equity and total assets of the firm, Tobin's Q is a market based measure and measures the market value of the firm. Firms that practice corporate governance effectively ensure better management and enhanced transparency and accountability in allocation of resources. Higher financial performance results in higher ROA and ROE which in turn impact the share prices positively and increase the market value of firm. An increase in the firm's share prices increases the market value of the firm (Mobius 2002).

Fama et al. (1969) asserted that market may react favorably or unfavorably to information and this is evidenced in the prices of the stock. This theory is based upon the efficient market hypotheses, where the markets adjust rapidly to fully impound information into share prices. In India also the firm performance is affected by capital market reactions to mandatory and voluntary disclosures. Black & Khanna (2007) in their study on investor reaction, subsequent to the reform announcement in 1999 and the introduction of Clause 49 in India, found that large firms gain on average, relative to small firms. While certain clauses of corporate governance reforms are mandatory others are voluntary. CSR reporting is voluntary in nature. Therefore the information content provided in such disclosures varies from firm to firm and across industries depending on their priorities. Ghazali Mohd (2008) asserted that disclosures with additional information reduces information asymmetry in the market, and in turn reduces the cost of capital and estimated risks associated with expected future returns.

In the present study firm's financial performance is measured using both market-based and accounting measures. ROA is an accounting based measure that indicates effectiveness in the use of company's assets. Tobin'Q (TOQ) is a market-based measure and is used to indicate the market perception of firm's performance. Firm's financial performance indicators for the purpose of this study are Tobin's Q (TOQ) and ROA.

Based on the arguments derived from the prior research, we intend to test the following hypotheses:

H0a: There is no significant difference in the adjusted mean scores of TOQ of the companies that did both CSR & financial reporting and those that did financial reporting alone.

H1a: There is significant difference in the adjusted mean scores of TOQ of the companies that did both CSR & financial reporting and those that did financial reporting alone.

H0b: There is no significant difference in the adjusted mean scores of ROA of the companies that did both CSR & financial reporting and those that did financial reporting alone.

H1b: There is significant difference in the adjusted mean scores of ROA of the companies that did both CSR & financial reporting and those that did financial reporting alone.

3. Research Methodology

I) *Data Collection*

A random sample of 100 companies is selected from the companies listed in the National Stock Exchange CNX 200 for the period 2010-11 and 2014-15. The top 200 companies from NSE are selected because they are more likely to have the resources and motivation for embracing corporate social reporting practices. The financial data is collected from company websites, annual reports and other financial data websites. The data on corporate social reporting is obtained through company websites and annual reports.

II) *Measurement of Variables*

Corporate reporting includes reporting on specific aspects of the firm such as financial reports, related party transactions, audit reports, remuneration of directors and corporate governance report among others. Reporting on CSR activities of the firm is a voluntary disclosure. Prior studies (Weir & Laing 2001; Keil & Nicholson 2003) have used dummy variables to represent corporate reporting practices. Similar methodology is used in this study where 1 will be assigned to a company that reports CSR activities in its annual report and 0 will be assigned to the company that reports only on financial and other aspects. Based upon this the companies are categorized into those doing financial reporting alone and those doing both CSR and financial reporting.

Tobin's Q is an indicator of how closely management is aligned to the interests of the shareholders. A higher value indicates that the firm is overvalued by the market because of stronger governance mechanism and good perception of the market. A lower Q value suggests greater managerial discretion and less effective governance mechanism of the firm. The study employs the following formula for calculating Tobin's Q,

Tobin's Q = Total Market Value /Total Asset Value

Return on Assets (ROA) is an accounting based measure that measures the efficiency of management in generating profits from firm's assets. Haniffa & Hudaib (2006) refer it to the effectiveness of the companies' assets in increasing shareholders' economic interests. It is expected that the corporate governance practices would have impact on this measure also. It is calculated using the following formula; ROA = Profit after tax/ Total Assets.

III) *Statistical Tools*

The statistical test employed in this study for the purpose of assessing impact of corporate social reporting on firm performance is Analysis of Covariance (ANCOVA). Assumptions for ANCOVA were checked. Normality tests and homogeneity tests were applied. The other assumption of ANCOVA which is to check whether the covariate and the independent variable interaction is significant or not was also applied. If it is significant the assumptions of ANCOVA are not met. However no values were found significant.

4. Results & Analysis

Table No: 1 Table showing the sample size of the two levels of the chosen companies' fashion of reporting

		Value Label	N
Reporting	1.00	CSR & Financial Reporting	20
	2.00	Financial Reporting only	34

The above table shows the number of companies doing both financial and CSR related disclosures in the year 2010-11 and those that do financial disclosure only in the year 2014-15.

Table No: 2 Table showing descriptive statistics of post scores of TOQ between the two levels of the chosen companies' fashion of reporting

Dependent Variable: TOQ post

Reporting	Mean	Std. Deviation	N
CSR & Financial Reporting	.3240	.20366	20
Financial Reporting only	.4976	.23009	34
Total	.4333	.23451	54

The above table shows the mean and standard deviation of post scores of TOQ of companies doing CSR and financial reporting and those doing financial reporting only.

Table No: 3 Table showing Levene's Test of Equality of Error Variances (the test to check the assumptions of normality of the data) of post scores of TOQ between the two levels of the chosen companies' fashion of reporting

Dependent Variable: TOQ post

F	df1	df2	Sig.
.302	1	52	.585

Tests the null hypothesis that the error variance of the dependent variable is equal across groups.

a Design: Intercept+TOQpre+Reporting

Prior to the ANCOVA test, Levene's test for equality of variances is performed. If the Levene test is positive ($p<0.05$) then the variances in the groups are different (the groups are not homogeneous), and therefore the assumptions for ANCOVA are not met. Here the p value is greater than the alpha value (0.05). Hence ANCOVA shall be performed.

Table No: 4 Summary of one way ANCOVA of post scores of TOQ between the two levels of the chosen companies' fashion of reporting.

Dependent Variable: TOQ post

Source	Type III Sum of Squares	df	Mean Square	f	Sig.	Remark
Reporting	.388	1	.388	**7.846**	**.007**	**$p < 0.05$**
Error	2.524	51	.049			
Total	13.055	54				
Corrected Total	2.915	53				

a R Squared = .134 (Adjusted R Squared = .100)

From the table no: 4, it is evident that the f value for company's fashion of reporting being 7.846 is significant with df = 1/51. It indicates that the adjusted mean scores of *TOQ* of the companies whether the company reported both CSR & Financial reporting or just financial reporting alone differ significantly considering the initial scores of TOQ as the covariate. Thus the null hypothesis, stated, "There will be no significant difference in the adjusted mean scores of TOQ of the companies who reported both CSR & Financial reporting and those who reported just financial reporting alone considering the initial scores of *TOQ* as the covariate" is rejected. Therefore it may be concluded that all companies who reported both CSR & Financial reporting and those who reported just financial reporting alone essentially influence the Tobin's Q, a popular market based measure to assess the financial performance of the company.

Table No: 5 Table showing descriptive statistics of post scores of ROA between the two levels of the chosen companies' fashion of reporting.

Dependent Variable: ROA post

Reporting	Mean	Std. Deviation	N
CSR & Financial Reporting	13.7035	4.86668	20
Financial Reporting only	15.5794	6.36426	34
Total	14.8846	5.87759	54

The above table shows the mean and standard deviation of post scores of ROA of companies doing CSR and financial reporting and those doing financial reporting only.

Table No: 6 Table showing Levene's Test of Equality of Error Variances (the test to check the assumptions of normality of the data) of post scores of ROA between the two levels of the chosen companies' fashion of reporting

Dependent Variable: ROA post

F	df1	df2	Sig.
3.146	1	52	.082

Tests the null hypothesis that the error variance of the dependent variable is equal across groups.

a Design: Intercept+ROApre+Reporting

Prior to the ANCOVA test, Levene's test for equality of variances is performed. If the Levene test is positive ($p<0.05$) then the variances in the groups are different (the groups are not homogeneous), and therefore the assumptions for ANCOVA are not met. Here the p value is greater than the alpha value (0.05). Hence ANCOVA shall be performed.

Table No: 7 Summary of one way ANCOVA of post scores of ROA between the two levels of the chosen companies' fashion of reporting.

Dependent Variable: ROA post

Source	Type III Sum of Squares	df	Mean Square	f	Sig.	Remark
Reporting	39.276	1	39.276	1.128	.293	$p > 0.05$
Error	1775.342	51	34.811			
Total	13794.763	54				
Corrected Total	1830.944	53				

a R Squared = .030 (Adjusted R Squared = -.008)

From the table no: 7, it is evident that the f value for company's fashion of reporting being 1.128 is non-significant with df = 1/47. It indicates that the adjusted mean scores of *ROA* of the companies whether the company reported both CSR & Financial reporting or just financial reporting alone do not differ significantly considering the initial scores of ROA as the covariate. Thus the null hypothesis, stated, "There will be no significant difference in the adjusted mean scores of ROA of the companies who reported both CSR & Financial reporting and those who reported just financial reporting alone considering the initial scores of ROA as the covariate" is accepted. Therefore it may be concluded that all companies who reported both CSR & Financial reporting and those who reported just financial reporting alone will have more or less similar RETURN ON ASSETS, a popular accounting based measure to assess the financial performance of the company.

5. Discussion

In this study corporate social responsibility reporting is considered an important aspect of corporate governance in India. The impact of CSR reporting along with financial reporting was tested on both market based measure and accounting based measure.

The hypotheses (i) H1a (ii) H0b were accepted as a result of analysis carried out on them. It was found that there is significant difference in the adjusted mean scores of TOQ of the companies that did both CSR & financial reporting and those that did financial reporting alone. CSR reporting along with financial reporting is an important aspect of transparency and disclosure and is considered important by investors and analysts both. A number of studies reveal the importance of CSR disclosures to market analysts in assessing a firm while arriving at market valuations. Higher market valuations can also be attributed to the possibility of reduced explicit claims (Freeman 1984; McGuire et al. 1988) due to enhanced disclosures. CSR influences banks and other institutional investors' investment decisions (Pava & Krausz 1996). Frooman (1997) also found that socially irresponsible behavior by firms lead to lower market valuations in the long run.

In this study it was found that there is no significant impact of CSR reporting & disclosures on accounting based measures. It could be reasoned that investors and analysts value the firms doing CSR disclosures as reflected by significant difference with respect to TOQ but such valuations by market analysts do not seem to influence the efficiency of management in improving accounting ratios.

6. Conclusions

Since CSR reporting has impact on market based measure of firm performance, it is recommended for future use by the companies. Managers may appoint corporate social responsibility committee to address the issues related to social and environmental risks and improve transparency and disclosures. Such CSR committee like other committees should have independent directors to monitor the strategy, implementation and progress of CSR related issues. By engaging in focused CSR related disclosures, managers' shall be able to elevate their firm's reputation as a socially responsible business enterprise. This shall be further reflected in firm's valuations by market analysts and managers will be able to encash the benefits of higher valuations.

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