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The Link between Corporate Social Performance and Financial Performance: Evidence from Indonesian Companies

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Abstract

This study examines the relationship of corporate social performance (CSP) to corporate financial performance (CFP) to determine if CSP is related to firm performance. Additionally, it examines whether firm size or industry affects the relationships between CSR and CSP. This study advances the literature as it examines this relationship for companies in a developing country, Indonesia, along with examining the impact of moderating variables on this relationship. Two models were developed: the first model was derived using slack resource theory and the second model was developed using the good management theory. Through the examination of 383 firms, the result of the study failed to find a significant relationship between CSP and CFP in either model. Further analysis, using the slack resource theory, did find that company size had a significant positive moderating effect on the relationship between CSP and CFP.

Key Words: *Corporate Social performance, financial performance, content analysis, stakeholder, good management theory, and slack resource theory.*

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Introduction

Friedman (1962/1970) in Griffin & Mahon (1997) and Ruf et al., (2001) argues that the main responsibility of a company is to its shareholders and, therefore, cost expenditures for social responsible activities are in violation of management's responsibility. Thus, such expenditures by the company often lead to controversies by its shareholders. These controversies have led to a mapping of views of a company, a concept going beyond Friedman's view of shareholders only. Two models explain the different views of the company: the input-output model and the stakeholder model (Donaldson & Preston, 1995). Under the input-output model, a company is assumed to exist as a result of the contributions resulting from stockholders, investors, suppliers, labor, and customers. The implication of this model is that other parties (i.e. community, employees, government agencies, specialty groups etc.) affecting or affected by the company are not considered in the system or subsystem of the company. Decisions made by the company will only consider those who are part of the system or subsystem. Thus, under the input-output model, the potential exists for the company to encounter conflict with these other groups not accommodated in the model through boycotts, lawsuits, and protests (Ruf et al., 2001).

Under the stakeholder view, all parties under the input-output model are considered in a company's system or subsystem along with all other groups in society affected by or affecting the company. Consequently, the decisions made by the firm should consider all parties or stakeholders. Under this view, share-

holders are only one of multiple stakeholder components that management should satisfy (Frederick et al., 1992). In addition to investors, suppliers, labor, and customers, they also need to consider people, community, governments, and all other stakeholders in making company decisions. The failure to consider all these stakeholders could result in conflict to the corporation. As a result, it is expected that a company will incur additional costs, such as environmental and community contribution, resulting in impacts on corporate social performance (CSP) and corporate financial performance (CFP).

Research examining the relationship between CSP and CFP has produced conflicting results, although a number of the findings indicate a positive association (see for examples: Worrell et al., 1991; Preston & O'Bannon, 1997; Frooman, 1997; Roman et al., 1999; Orlitzky & Benjamin, 2001; Murphy, 2002; and Simpson & Kohers, 2002). Furthermore most of these findings were derived from the evidence coming from developed countries. The objectives of this paper are twofold: First, it adds to the literature on the relationship between CSP and CFP by using a model containing moderating variables and second, it provides valuable insights on this relationship for developing countries, especially Indonesia. As a result, this research will not only contribute to the debate on the link between CSP and CFP but also extend the literature by examining the impact of different cultures and systems on this relationship.

Literature Review and Hypotheses Development

The debate on the relationship between

CSP and CFP involves two important issues: direction and causality of the relationship (Preston & O'Bannon, 1997). Based upon the literature review, the relationship between CSP and CFP could be positive, neutral, and negative. Griffin & Mahon (1997) reviewed 51 studies discussing the relationship between CSP and CFP from the 1970's through the 1990's. The Griffin & Mahon's study (1997) mapped the issue of direction of the relationship between CSP and CFP for the periods. In the 1970s, there were 16 studies reviewed with 12 of which had positive relationship. During the period of the 1980s and 1990s, the positive direction of the relationship accounted for 14 of 27 studies and seven of the eight studies, respectively. Negative results were supported by only one study in the 1970s, 17 studies in the 1980s, and 3 studies in the 1990s. Inconclusive findings were found by four studies in the 1970s, five studies in the 1980s, and no finding in the 1990s. It should be noted that one or more studies could have one or more findings in the work of Griffin and Mahon (1997).

As the study of Griffin & Mahon (1997) was not all inclusive, there are additional studies contributing to the direction of the association between CSP and CFP relationship in the 1990s. During this period, positive direction of the relationship has been supported by Worrell et al. (1991), Preston & O'Bannon (1997), Waddock & Graves (1997), Frooman (1997), and Roman et al. (1999). Negative results are supported by Wright & Ferris (1997). Furthermore, in the 2000s, there are some researchers adding to the debate on the link between CSP and CFP with different perspectives of methodology. Positive results were supported

by the works of Orlitzky (2001), Orlitzky & Benjamin (2001), Ruf et al. (2001), Konar & Cohen (2001), Murphy (2002), Simpson & Kohers (2002), Orlitzky et al. (2003), and Mahoney & Roberts (2007). Patten (2002) found a negative correlation. Researchers such as McWilliams & Siegel (2000 and 2001) and Moore (2001) found inconclusive results. Fauzi (2004) using content analysis of annual reports of companies listed on the New York Stock Exchange for the period of 2004 also provided support for inconclusive results.

In addition to providing different results on the relationship direction from that of Griffin & Mahon (1997), Roman et al. (1999) argued that errors existed in their study resulting in erroneous conclusions. For those findings, determined to be generalized erroneously by Griffin & Mahon (1997), Roman et al. (1999) reclassified findings from negative to positive direction and from positive or negative to inconclusive result. In summarizing the direction of relationship between CSP and CFP, Roman et al. (1999) removed research with problems of invalid measurement and replaced them with new studies for those supplanted by later studies. Roman et al. (1999) ended up with a total of 46 studies comprising 51 research results, 33 out of which are positively correlated.

In a more recent work, Margolis & Walsh (2003) also mapped studies investigating the relationship between CSP and CFP. They followed the works of Griffin & Mahon (1997) but used a wider time period (1972 – 2002) resulting in analysis of 127 published studies. Of these studies, 70 studies (55%) reported having a positive relationship, seven studies suggested a negative rela-

tionship, 28 studies supported inconclusive results, and 24 studies found the relationship went in both directions. Gray (2006), in his review of studies investigating the relationship between CSP and CFP, argued that results are inconclusive. This argument is also supported by Murray et al. (2006) in their cross section data analysis. However, using a longitudinal data analysis, they found evidence to the contrary. Hill et al. (2007) investigated the effect of corporate social responsibility on financial performance in terms of a market-based measure and found positive results in the long-term.

The second issue that Griffin & Mahon (1997) raised is about the causality. In an effort to meet the stakeholder's expectation, companies should try to improve their CSP, which often comes at the expense of also trying to improve their CFP. The question that emerges is whether a company is better off focusing first on CSP or focusing first on CFP. Waddock & Graves (1997) and Dean (1998) put forward two theories to answer the question: slack resource theory and good management theory. Under the slack resource theory, a company should focus on its financial position, allowing it to contribute to the CSP. Conducting good social performance requires funds that might result from the success of financial performance. According to this theory, financial performance comes first. A good management theory holds that social performance comes first. Based on this theory, a company perceived by its stakeholders as having a good reputation will result in a stronger financial position (through market mechanism).

Simplistic views of relationship between

CSP and CFP have led to ambiguity in results in prior studies. Nevertheless, problems may have emerged because the views did not take into account whether some variables might have moderated the effect of CSP and CFP. As suggested by previous research, this study examines the relationships between CSP and CFP by incorporating the following suggested variables that may influence the relationship: company size, and industry type (Waddock & Graves, 1997; Griffin & Mahon, 1997 and 1999; Orlitzky, 2001; Ruf et al., 2001; Wagner, 2001; Moore, 2001; Simpson & Kohers, 2002; Orlitzky et al., 2003; and Itkonen, 2003).

Prior research has not taken into account moderating variables. The presence of a moderating variable can often modify the relationship between the independent and dependent variables. According to Waddock & Graves (1997) and Itkonen (2003) company size is related to CSP, as larger companies have been found to be more socially responsible than smaller ones. These results are also supported by Orlitzky (2001) who also found that the size of a company affected the relationship between CSP and CFP. According to Orlitzky (2001) and Itkonen (2003), CSP is related to the firm size since in the beginning, entrepreneurial strategies focus on the basic economic survival and not on ethical and philanthropic responsibilities. As the firm grows, these same firms began to focus more on their CSP responsibility. Based upon these arguments, it is expected that the size of a company will be a moderating variable and will affect the relations between CSP and CFP (Orlitzky, 2001 and Itkonen, 2003).

Researchers also suggest that industry

type should be taken into account when analyzing the relationship between CSP and CFP. As suggested by prior research, industry can affect the relationship between CSP and CFP (Waddock & Graves, 1997; Griffin & Mahon, 1997; Ruf et al., 2001; Moore, 2001; and Simpson & Kohers, 2002) and will also be treated as a moderating variable.

Based on the literature review, we examine the following hypotheses:

H1: The relationship between CSP and CFP in Indonesia is positive

H2: Company size affects the relationship between CSP and CFP in Indonesia

H3: Industry type affects the relationship between CSP and CFP in Indonesia

Method

Data and Sample Selection

An initial sample of 407 companies was selected from companies listed on the Jakarta Stock Exchange for the period of 2002 and 2003 that meet the following criteria:

1. They represent types of industry (manufacturing and non-manufacturing)
2. They have been registered on the Jakarta Stock Exchange for at least two years

Missing Corporate Annual Reports (CAR) reduced the sample size by 24 companies, resulting in a final sample of 383 companies comprising 246 manufacturing and 137 non-manufacturing companies.

The CAR for these companies was obtained from the official web site of the Jakarta Stock Exchange, the companies' web site, and other web sites. Informa-

tion on CSP was collected from the CAR, company social reports, CSP Indonesia, CSP news capital market directory, Jakarta stock exchange websites, other web sites and other electronic news. Information on all financial variables, total assets and industry was collected from the CARs. Consistent with prior literature, data on CSP and financial performance have a one-year lag (Waddock & Graves, 1997).

Measure of CSP

CSP is measured and calculated through content analysis for each company following the approaches of both by Kinder, Lydenberg Domini (KLD), an United States based independent rating company and by Michael Jantzi Research Associate (MJRA), an independent rating company in Canada. Both these companies measure several dimensions of the CSP to arrive at a total measure of CSP. These dimensions include community issues, diversity in the workplace, employee relations, environmental performance, international issues, product and business practices, and other variables concerning compensation, confidentiality, and ownership in other companies.

Both positive and negative social responsible information was collected through examining the CAR, company corporate social reports, along with examining information obtained from the capital market directory, Jakarta stock exchange websites, other web sites and other electronic news regarding the sampled companies. CSP for each company was assessed on a scale of -2 to +2 for each rating. A -2 rating for any dimension indicates major concern, -1 indi-

cates a notable concern, 0 indicates no notable or major strength and concern, +1 indicates a notable strength and +2 indicates a major strength. A composite CSP score was then calculated by summing the scores of each dimension for each company.

Measure of CFP

Following the works of Waddock & Graves (1997) and Roman et al. (1999), Return on Assets (ROA) and Return on Equity (ROE) were used separately to measure a firm's financial performance. ROA is defined as the ratio of net income after tax to total assets and ROE is defined as the ratio of net income after tax to outstanding shares. Information on ROA and ROE was collected from the CAR.

Measure of Moderating Variables

Two moderating variables are used in this study: size and industry. There are three approaches used to measure company size in literature: total assets (Waddock & Graves, 1997; Simerly & Li, 2001; and Moore, 2001), the number of people employed (Simerly & Li, 2001) and annual sales of the firm (Simerly & Li, 2001; Ruf et al., 2001; and Moore, 2001). This study uses the measure of total assets to measure company size as Waddock & Graves (1997) argues that total assets are the "money machine" to generate sales and income. Dummy variables are used to control for performances that may vary by industries. A variable of 1 was assigned to companies that were manufacturing and 0 was assigned to non-manufacturing companies.

Result and Discussion

Descriptive Statistics

Table 1: Descriptive Statistic

| Variables | N | Mean | SD |
|--------------------------------|-----|-------|--------|
| CSP index | 383 | 4.0 | 1.7 |
| ROA (in %) | 383 | 2.5 | 27.2 |
| ROE (in %) | 383 | 5.8 | 74.9 |
| Total Asset (in Rp Billion) | 383 | 3,862 | 14,349 |

Table 1 shows the mean and standard deviation for the CSR composite score. The mean was 4.0 with a standard deviation of 1.7. The sampled companies have a mean ROA and ROE of 2.5% and 5.8%, respectively, with standard deviations of 27.2% and 74.9%, respectively. Company size, as measured by total assets is Rp 3,862 billion with a standard deviation of Rp 14,349 billion.

Regression Analysis

Tables 2, 3, and 4 show the results of our regressions models used to examine the relationships between CSP and CFP. Table 2 shows the results of our regression using CSP as the dependent variable. Based upon the slack resource theory (Waddock & Graves, 1997) CSP is treated as a dependent variable, while financial performance is treated as independent variable and company size, industry type and related interaction terms are treated as moderating variables. Tables 3 and 4 show the results of our regressions using CFP as the dependent variable, CSP as the independent variable and the interaction terms as moder-

ating variables. This model is consistent with the good management theory (Waddock & Graves, 1997).

Table 2 indicates that the relationship of CSP and CFP, for both measures of financial performance (ROA and ROE), is

insignificant suggesting that the link between CSP and CFP is inconclusive in nature. Additionally, no significant relationship was found between the relationships of industry type and CSP. However, the relationship between size and CSP is significantly positive at $p < .000$

Table 2: Regression Analysis Using CSP as Dependent Variable

| Independent, Control, and Moderating Variables | Coefficient | Standard Error | t-Value | Prob |
|--|-------------|----------------|---------|-------|
| ROA | 0.113 | 0.016 | 0.443 | 0.658 |
| ROE | 0.098 | 0.003 | 0.791 | 0.435 |
| Company Size | 0.416 | 0.000 | 4.350 | 0.000 |
| Industry Type | 0.039 | 0.177 | 0.774 | 0.439 |
| Interaction: | | | | |
| ROA/Company Size | 0.142 | 0.000 | 1.576 | 0.116 |
| ROA/Industry Type | -0.116 | 0.017 | -0.444 | 0.658 |
| ROE/Company Size | -0.244 | 0.000 | -0.788 | 0.075 |
| ROE/Industry Type | -0.118 | 0.004 | -0.845 | 0.398 |
| Model Summary | | | | |
| Adjusted R Square | | | | 0.083 |
| F-Statistics | | | | 5.323 |
| Prob | | | | 0.000 |

Table 3: Regression Analysis Using ROA as Dependent Variable

| Independent, Control, and Moderating Variables | Coefficient | Standard Error | t-Value | Prob |
|--|-------------|----------------|---------|--------|
| CSP | 0.000 | 0.709 | -0.001 | 0.999 |
| Interaction: | | | | |
| CSP/Company Size | 0.064 | 0.000 | 0.374 | 0.709 |
| CSP/Industry Type | -0.001 | 1.130 | 0.008 | 0.994 |
| Model Summary | | | | |
| Adjusted R Square | | | | 0.596 |
| F-Statistics | | | | 95.103 |
| Prob | | | | 0.000 |

Table 4: Regression Analysis Using ROE as Dependent Variable

| Independent, Control, and Moderating Variables | Coefficient | Standard Error | t-Value | Prob |
|--|-------------|----------------|---------|-------|
| CSP | 0.014 | 1.950 | 0.323 | 0.747 |
| Interaction: | | | | |
| CSP/Company Size | -0.104 | 0.000 | -0.608 | 0.544 |
| CSP/Industry Type | 0.057 | 3.108 | -0.637 | 0.525 |
| Model Summary | | | | |
| Adjusted R Square | | | 0.597 | |
| F-Statistics | | | 95.491 | |
| Prob | | | 0.000 | |

level and the interaction terms of size and ROE with CSP is marginally significantly negatively at a $p < .075$ level. Using the model derived from the slack recourse theory (Waddock and Graves, 1997), the evidence indicated in table 2 provided a reasonable basis to reject the hypotheses 1 and 3 and supports hypothesis 2.

The good management theory (Waddock and Graves, 1997) formed the basis to derive the regression model using CFP as a dependent variable. As shown in tables 3 and 4, none of the independent, control or moderating variables are significant. Hypothesis one is not supported as we failed to find a significant relationship between CSP and CFP. Similarly, hypotheses 2 and 3 are not supported as we also failed to find any significant relationships between the effect of company size or industry type on the relationship between CSP and CFP.

Our finding of a significant positive relationship between CSP and company size provide support for the slack theory, indicating that larger companies participate in more socially responsible ac-

tions. Meanwhile, smaller companies appear to have reluctance to invest in CSP, possibly because they fear it will negatively affect CFP. These findings contribute to the overall research debate on the relationship between CSP and CFP along with enriching our understanding of this relationship for companies in developing countries.

Conclusion, Implication, and Limitation

Previous studies on the relationship between CSP and CFP yield conflicting results; some are positive, negative, and neutral. All of the studies use some control variables (total assets, number of employees, financial risk, type of industry, and research and development activities) in their models. Unlike previous studies, this study uses some of the variables as moderating variables: company size and industry type to examine whether these variables can improve our understanding of the relationship between CSP and financial performance.

The key findings of this study are as follows:

1. Using the model derived from the slack resource theory, we find no relationship between CSP and CFP, though we did find that company size does affect the relationship of CSP and CFP.
2. Using the model derived from the good management theory, we found no evidence supporting a relationship between CSP and CFP.

These findings have important implications for the Indonesian business sector and capital market regulators, like Bapepam. Recently new laws have been agreed upon by legislators of Indonesia to improve CSP. Article 77 of the law now obliges Indonesian companies to conduct CSP. Furthermore, it is expected that the capital market regulator (Bapepam) and Indonesian standard setter will include social and environmental performance as mandatory disclosure. As it is becoming increasingly important for companies to integrate social and environmental concerns in their business strategies, it is important for managers of these companies to understand the relationship between CSP and CFP.

Future research may want to consider an alternative measure of CSP that includes more objective measures to perform content analysis, such as survey approach as described by Igalens & Gond (2005). The relationship between CSP and CFP may also be extended to include a balanced scorecard in hopes that a good theoretical framework can explain better the practice of company's CSP.

Limitations to the study include judgmental factors resulting from biases of the reviewers performing the content analysis in determining CSP. In addition,

all dimensions identified by MJRA could not be found in some company annual reports. A potential bias may also exist as the negative aspects of CSP were often hard to obtain.

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