Is CSR compatible with maximization of shareholder value?

Introduction

The aim of this essay is to show that CSR has a positive effect on profitability of a corporation. In support of this position it will be argued, firstly, there indeed is a positive relationship between corporate social performance and Return on Investment(ROI) secondly, CSR has a positive effect on Return on Asset (ROA) finally, CSR has a positive effect of CSR on Return on Equity(ROE).

Over the last decades, Corporate Social Responsibility (CSR) has become a dominant topic in the corporate world. Wheelen and Hunger (2012) suggest that corporation has responsibilities to society that go beyond just making profit. CSR can be broadly defined as the activities making companies good citizens who contribute to society's welfare beyond their own self-interest (Khanifar et al., 2012). While Milton Friedman (1970) proposed: "there is one and only one social responsibility of business to use its resources and engage in activities designed to increase its profits so long as it stays in the rules of the game, which is to say, engages in open and free competition, without deception or fraud" (Friedman, 1970).

By increasing attention on the corporate social responsibility (CSR), firms are not only required to focus on generating better returns for shareholders, but also they are asked to take responsibilities for firms' other stakeholders like customers, employees, society etc., socially and environmentally so leading to the fact that CSR and corporate social performance are directly linked together. But the question is how CSR can affect a firm's profitability.

So the argument of this essay is to show that CSR has a positive effect on profitability of a corporation. Friedman believed that social responsibility is either an expense or investment and there is no mid-way between the two. In the business world, most money-spending activities fall into either of the two categories. Expenses are the economic costs that businesses incur to earn their revenue. Examples of such include energy bills of a factory, car rental costs and so forth and a profit maximizing business would cut back all possible expenses in order to maximize the profits in the fixed-sized pie composed of either expenses or profits; the logic is that spending one more dollar on electricity for nothing would just decrease one dollar of profits (Fung, 2015).So when talking about the negative financial impacts that CSR brings to the company, the biggest reason is the high investment on CSR activities or initiatives. Moreover, some researchers also think CSR is only an investment for the company and it will contribute less to profitability (Rainey, 2006). Some added costs, such as establishing more environmental friendly technology, maintaining plants, and training employees strengthen the financial burden for the company and bring economic disadvantages (Balabanis et al., 1998). However, a good performance of CSR can be seen as an investment which brings better reputation and market opportunities to the company (Pava & Krausz, 1996). Additionally, Balabanis et al. (1998), McGuire et al. (1988) and Barnett (2007) argue that a firm which performs higher-level social responsibility may experience fewer labor problem; face fewer financial risks from bankers, investors, government; and reduce costs from monitoring, Because of these advantages of CSR, one company can improve its relationship with its stakeholders on the basis of mutual trust. Also the corporate social responsibility often earns media coverage for firms. The other benefit of CSR is higher social status of corporations within local communities. Firms may thus have a stronger lobbying power, and be able to earn social license to keep their businesses running. Take a firm in the coal mining industry as an example; it causes serious pollution and may deter the overall development of the area surrounding it. It may be of overall social interest to stop the firm from operating. However, with a good social responsibility program and relationship between local parties, firms may be granted exploration rights, and possibly franchise in the local areas. The potential market barriers and right to 'do business, 'enable the firm to reap the profits that it might be unable to obtain, when without a CSR program (Fung, 2015). So all of the mentioned positive results of CSR empower the corporation which leads to improved profitability.

For the purpose of this essay, profitability will be measured by ROA, ROE and ROI. So the CSR dimension of the firm is considered as an independent variable while ROI, ROA and ROE are dependent variables.

ROI (Return on Investment)

ROI measures the gain or loss generated on an investment relative to the amount of money invested. ROI is usually expressed as a percentage and is typically used for personal financial decisions, to compare a company's profitability or to compare the efficiency of different investments.

If we consider CSR as an investment, ROI of the corporation should be enhanced by active performance in CSR although in some cases it may not be ethical to do CSR with the aim of making more profit. We cannot ignore the positive effects of CSR on reputation of the firm. It may be argued that in the short term CSR can be counted as an expense but in the long term it helps to gain more loyal customers alongside other benefits of good reputation which were mentioned before.

Regarding the definition of ROI, if net profit increases, it results in increase of ROI. Based on a study of a banking sector of Pakistan:

Results describe that there is positive relationship of CSR with net profit in the banking sector of Pakistan. It shows that stakeholders are getting benefits by giving funds for CSR because the profit of the banks is increasing with the increase in CSR. Performance of the management is measured through net profit. Management will increase donations because of positive relationship between donation and net profit. CSR relation with net profit is positive that explain its positive impact on the net profit (Malik & Nadeem,2014).

There are cases where a direct relationship between an investment in CSR and financial benefit can be established. In particular, investments in resource efficiencies such as energy or water conservation often result in cost savings. Return on investment(ROI) is easy to calculate and the financial benefit of efficiency initiatives are easy to establish.

A good example that illustrates this relationship comes from Wal-Mart which was able to reduce their environmental impact and save significant costs by tackling inefficiencies in their value chain. In a direct CSR effort, the company reduced packaging saving millions in lower disposal costs, and invested in better route planning for its huge fleet of trucks which cut out 100 million miles from their 2009 delivery routes, saving $200 million in costs and reducing their carbon footprint by a similar quantum (Whiteman, 2009).

ROA (Return on Asset)

ROA percentage shows how profitable a company's assets are in generating revenue. It is given by the ratio between net income and total assets. This ratio tells us what the company can do with what it's got. If a company has an increase in profitability, the ROA ratio will increase.

Based on a Harvard Business Review article, the best way to measure company performance is ROA because "ROA explicitly takes into account the assets used to support business activities. It determines whether the company is able to generate an adequate return on these assets rather than simply showing robust returns on sales." (J. Hagel & J. Brown, 2010)

"We have proven by the empirical data from the Telecom Industry; CSR can be one of alternatives as business strategic to solve ROA problem in Indonesia Telecom Industry. Increasing 1% in CSR makes 73,9% increasing in ROA" (Firli & Akbar, 2016).

ROE (Return on Equity)

ROE is used a great deal in economic literature (Bowman & Haire, 1975; Bregdon & Marlin, 1972; Perket & Eilbirt, 1975; Spicer, 1978; Preston, 1978; Cowen et al., 1987; Waddock & Graves , 1996, 1997; Preston & O'Bannon, 1997). ROE is equal to a fiscal year's net income (after preferred stock dividends but before common stock dividends) divided by total equity (excluding preferred shares), expressed as a percentage. It measures the rate of return on ownership interest (shareholders' equity) of common stock owners. It measures a firm's efficiency at generating profits from every dollar/euro of net assets (assets minus liabilities), and shows how well a company uses investment dollars/euros to generate earnings growth.

From the result, it shows that CSR has direct relationship with both ROA and ROE for this model. This result indicates, for ROA, every unit increase in CSR, firm ROA will increase by 0.14 units, meanwhile for ROE, every unit increase in CSR, firm ROE will increase by 0.19 units. This result support the correlation test indicates there is strong and positive relationship between CSR with ROA and ROA (Ahamed, Almsafir & Al-Smadi, 2014).

The regression results reveal the fact that Corporate Social Responsibility has Positive relationship with return on equity. CSR includes donation, spending of banks on education of employees and people living in society, amounts given for the better health of employees and other people of community, social welfare. Preferred and Common shareholder's return will increase by spending on CSR which will decrease the difficulties of management. This positive relation between CSR and ROE will motivate other companies to invest on CSR (Malik & Nadeem,2014).

Further evidence that shows the positive relationship between CSR and profitability is the performance of the banks of Ghana. The positive relationship between CSR practices and financial performance has been confirmed as they mentioned: "our results indicate that banks strongly believe that CSR activities promote socioeconomic development. Moreover, on average banks agree that CSR activities promote long-term return on equity for businesses, serve as a source of competitive advantage, attract investors and enhance the implementation of core business activities" (Ofori, Nyuur, S-Darko, 2012).

It is an interesting topic as this question can help companies who implement CSR and want to have a balance between its CSR performance and financial performance. On the other hand, this is also a controversial topic as there are a number of empirical studies based on different variables from different scholars showing different results and opinions on it. Some scholars claim that there is a positive relationship between CSR and profitability while other studies show that CSR has a negative relationship with making a profit or no relationship. However,the majority of empirical research merely focus on measuring the relationship between corporate social responsibility (CSR) and profitability/financial performance in order to identify whether the association is positive or negative. Only a few studies pay more attention to the internal connection to explain how the relationship between CSR and profitability emerges. The process of explaining how the question is regarded as a mediating process according to Surroca et al. (2009) and Peloza (2009). In that mediating process, both intangible resources, e.g. innovation, brand value, customer loyalty etc., and tangible resources, e.g. costs for energy use and water consumption etc., have impacts on the relationship, and help to define the relationship between CSR and profitability. Hence, it is also significant and necessary to analyze and deepen the understanding of how CSR influences the profitability, in order to explain the causality in the relationship between CSR and a firm’s profitability. (Jiao & Xie, 2013)

Conclusion

The purpose of this essay was to argue that there is a positive relationship between CSR and profitability of a corporation. Based on the three mentioned ratios for calculating profitability (ROI, ROA, ROE), some studies showed no significant relationship between CSR and profitability while some confirmed a positive relationship. It can be concluded that in the short run CSR can be seen as a cost but CSR can be seen as a long run investment which profits both corporation and stockholders.

With regard to the relationship between CSR and corporate profitability, many researchers concluded that CSR and profitability are inter-connected in a positive way; namely they organize a “virtuous circle” (Orlitzky et al., 2003), which means a better social performance leading to a better financial performance, and better financial performance also facilitates a better CSR (Sun, 2012; Orlitzky et al., 2003; Waddock & Graves, 1997).

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