

Corporate social responsibility and financial performance in the Australian context

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The concept of social responsibility of corporations has engendered considerable interest in Australia in recent years. While previous research on the relationship between corporate social responsibility and financial performance has largely been based on international data, this paper examines the relationship between the adoption of corporate social responsibility and the financial performance of companies within Australia. A number of economic drivers for corporate social responsibility have been identified that may explain its voluntary adoption by companies. Our preliminary results revealed no statistically significant relationship between corporate social responsibility and financial performance; however, a number of opportunities for refining the research were identified.

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Introduction

There is currently a debate on the extent to which company directors and managers should consider social and environmental factors in commercial decision making. An approach to decision making that routinely encompasses these factors may be described as corporate social responsibility.

A view is emerging that corporate social responsibility can contribute to the financial performance of a company. This approach, which has been described as the 'enlightened shareholder approach', suggests that corporate decision-makers must consider a range of social and environmental matters if they are to maximise long-term financial returns.

This paper presents some preliminary findings about the relationship between the adoption of corporate social responsibility and the financial performance of Australian companies, and identifies opportunities for further quantitative research in this area.

Corporate social responsibility

While there is no universally accepted definition of corporate social responsibility, it is usually described in terms of a company considering, managing and balancing the economic, social and environmental impacts of its activities (PJC 2006). The notion of corporate social responsibility as a part of the core business operations of a company, rather than a separate 'add on', distinguishes it from corporate philanthropy which may be funded out of operations that are damaging to the communities in which business is conducted.

The extent to which company directors and managers should consider social and environmental factors in making decisions, rather than focusing exclusively on maximising short-term accounting profit, has been the subject of much discussion in recent years. In Australia, the issue has been raised in the context of corporate donations following the 2004 Boxing Day Tsunami, the (eventual) decision by the James Hardie group to fund asbestos liabilities owed by former subsidiary companies, and most recently the findings of the Cole Royal Commission that the AWB may have engaged in unlawful conduct to secure export contracts to Iraq. International developments in corporate law have also played a part in promoting interest in this issue, for example the reformulation of directors' duties in the United Kingdom

Companies Act 2006 to recognise more explicitly the 'enlightened shareholder' model of corporate governance.²

In 2006, both the Parliamentary Joint Committee on Corporations and Financial Services and the Corporations and Markets Advisory Committee released reports examining the extent to which Australian companies should adopt corporate social responsibility. The reports concluded that corporate social responsibility can be an important means for companies to manage non-financial risks and maximise their long-term financial value.

... a well managed company will generally see it as being in its own commercial interests, in terms of enhancing corporate value or opportunity, or managing risks to its business, to assess and, where appropriate, respond to the impact of its activities on the environmental and social context in which it operates. Companies that fail to do so appropriately may jeopardise their commercial future (CAMAC 2006).

Companies that embrace the concept of corporate responsibility are realising that the long-term financial interests of a company are not 'mutually exclusive' with acting fairly in the interests of stakeholders (other than shareholders) (PJC 2006).

The reports also confirmed that Australian corporate law provides sufficient flexibility for corporate decision-makers to consider social and environmental factors when making commercial decisions.

Economic drivers for corporate social responsibility

Drawing on the experiences of those companies that have adopted corporate social responsibility, commentators have identified several ways in which this approach to business decision-making may lead to improved financial performance.

The following 'economic drivers' have been identified by the World Economic Forum and Business in the Community as explaining the voluntary adoption of corporate social responsibility by companies across the world (ADL 2003). It is suggested that these drivers do not operate in isolation, and that different companies may have different drivers. Various drivers may also be stronger in different sectors and for

2 Section 172 of the Companies Act 2006 imposes a duty on directors to promote the success of the company, and in doing so to have regard to: the long-term consequences of any decision; the interests of employees; the need to foster the company's business relationships with suppliers, customers and others; the impact of operations on the community and the environment; and the desirability of the company maintaining a reputation for high standards of business conduct.

different companies. A move to adopt corporate social responsibility may arise from a combination of drivers.

Employee recruitment, motivation and retention

Recent surveys indicate that corporate social responsibility is increasingly an important factor in attracting and retaining a talented and diverse workforce (Globescan Inc 2005). Companies that account for the interests of their employees by offering good working conditions will achieve better performance in terms of quality and delivery, and, therefore, experience higher levels of productivity.

Learning and innovation

Learning and innovation are critical to the long-term survival of any business. Corporate social responsibility can be a vehicle for business to respond to environmental and societal risks and turn these into business opportunities.

Reputation management

Companies operate in a market of opinion. How companies are judged by customers, suppliers and the broader community will have an impact on their profitability and success. Corporate social responsibility offers a means by which companies can manage and influence the attitudes and perceptions of their stakeholders, building their trust and enabling the benefits of positive relationships to deliver business advantage.

Risk profile and risk management

Corporate social responsibility offers more effective management of risk, helping companies to reduce avoidable losses, identify new emerging issues and use positions of leadership as a means to gain competitive advantage.

Competitiveness and market positioning

Corporate social responsibility branding can draw consumers away from competitors and thereby improve profitability.

Operational efficiency

Corporate social responsibility can offer opportunities to reduce present and future costs to the business thereby increasing operational efficiency.

Investor relations and access to capital

The investment community is increasingly viewing corporate social responsibility as akin to long-term risk management and good governance practices. Recent surveys indicate that analysts place as much importance on corporate reputation as they do on financial performance (Hill & Knowlton 2006).

Licence to operate

Companies that fail to manage their responsibilities to society as a whole risk losing their licence to operate – a concept whereby a company's stakeholders grant the company an unwritten authority to do business. This may be evidenced by favouring competitors, boycotts or calls for deregistration.

Previous research

There have been a number of studies based on United States and European data that seek to test the extent to which the economic drivers for corporate social responsibility deliver improved financial performance. The studies adopt different methodologies for measuring corporate social responsibility and financial performance, and not unexpectedly present quite different results.

A notable source is a meta analysis undertaken by Orlitzky et al (2003), who integrated 30 years of research from 52 previous studies and used meta analytical techniques to support the proposition that corporate social performance and corporate financial performance are positively correlated and statistically significant. Interestingly, the meta analysis found a higher correlation between financial performance and a company's management of its social impact than between financial performance and a company's management of its environmental performance.

Studies by investment analysts and funds managers on the performance of socially responsible investment fund products and sustainability indices are also regularly reported in order to attract investors and encourage participation.

For example, in 2005 AMP Capital Investors published an analysis of the corporate social responsibility rating technique it uses to manage its Sustainable Future Australian Share Fund. By applying its rating technique to the approximately 300 listed Australian companies and analysing their financial performance from a 10 year period, it determined that companies with a higher corporate social responsibility rating outperformed companies with a lower corporate social responsibility rating by more than 3.0 per cent per annum over a 4 and 10 year period (Rey and Nguyen 2005).

Similarly, in 2003 the Dow Jones Sustainability Indexes (DJSI), which includes over 300 companies from 22 countries that lead their industries in terms of corporate sustainability, reported that, compared with the previous year, the DJSI World Index outperformed the mainstream market. During this period, the DJSI World Index increased by 23.1 per cent, whereas the mainstream indices, the Dow Jones World Index and the Morgan Stanley Capital International (MSCI) World Index, increased by 22.7 per cent and 21.2 per cent, respectively (in USD) (SAM Indexes GmbH 2003).

This paper seeks to contribute to the existing body of work in this area by examining the extent to which corporate social responsibility contributes to financial performance in the Australian context.

Measuring corporate social responsibility

An initial challenge in testing the relationship between corporate social responsibility and financial performance is identifying those companies that have adopted corporate social responsibility. This is because corporate social responsibility reflects an approach to internal decision making, the presence or absence of which may not easily be determined by external observers.

The approach that was adopted for this paper was to identify those companies that issue a sustainability report, and treat those companies as having adopted corporate social responsibility. The preparation of a sustainability report provides information to external stakeholders about the conduct of a company, allowing consumers, employees, investors and others to make informed decisions when dealing with the company. Importantly, the preparation of a sustainability report also provides company management with information about social and environmental performance, facilitating improved decision making. It may be the case that it is not until information is collected for public dissemination that senior managers become aware of an issue.

Generally sustainability reports provide information about a company's environmental performance, such as energy efficiency, water usage and greenhouse gas emissions, as well as their social performance, such as their staff recruiting and retention policies and engagement with stakeholders. There are a number of voluntary reporting guidelines and sets of indicators available for these companies; the most widely used is the Global Reporting Initiative.

One limitation of this approach to identifying companies that have adopted corporate social responsibility is that it may give more of an indication of a company's willingness to report, rather than the extent to which company decision makers consider social and environmental factors in making decisions. While acknowledging

this limitation, we would caution that one should not understate the usefulness of sustainability reporting as an indicator of corporate social responsibility for the above reasons.

An alternative approach to measuring corporate social responsibility would be to draw on existing corporate social responsibility indices such as the Corporate Responsibility Index. This index was initially developed in the United Kingdom by the Business in the Community initiative, and is administered in Australia by the St James Ethics Centre. Participating companies are assessed against a corporate responsibility framework, including an examination of how corporate responsibility is translated from strategy into mainstream management practice, and how material risks are monitored and managed. The company's response is then externally audited, and results published. The reason this approach was not used for this exercise was that a relatively small amount of companies participate at this point in time.

A second alternative approach to measuring corporate social responsibility would be to draw on the criteria used by socially responsible investment funds to identify appropriate investments. The Ethical Investment Association (2006) has stated that there are now \$11.98 billion in managed investments and super funds that identify themselves as socially responsible (EIA 2006). The reason that this approach was not used for this exercise was that the investment criteria vary across investment funds, and there is no objective means for determining which is superior.

Methodology

We examined the relationship between financial performance and corporate social responsibility across the top 300 ASX listed companies for the 2005 financial year. A total of 277 companies remained in our sample after companies with missing data were eliminated.

As discussed above, we based our corporate social responsibility measurement on whether companies made separate sustainability disclosures beyond what is required of them by the regulatory framework. Data was gathered from publicly available information, as well as a confidential list provided to us by the Department of Environment and Water Resources and the Centre for Australian Ethical Research. As in the study conducted by McWilliams and Siegel (2000), our measure of corporate social responsibility is a dummy variable.³ This variable has a value of one if the firm

3 As there is no quantitative measurement of corporate social responsibility in Australia it was not possible for us to quantify this value. Using a dummy variable allowed us to measure the effects of corporate social responsibility on financial performance by saying that it is either present for a particular company or it is not.

has adopted corporate social responsibility and a value of zero if it has not (Gujarati 1999).

Accounting measures, as opposed to market measures, were used to evaluate the financial performance of each company. The financial performance measures used were return on assets, return on equity and return on sales. Each of these accounting measures gives us different information about a company (McGuire, Sundgren and Schneeweis 1988).

Return on assets represents the amount of earnings (before interest and tax) a company can achieve for each dollar of assets it controls and is a good indicator of a firm's profitability. Return on equity measures how well a company uses reinvested earnings to generate additional earnings, giving a general indication of the company's efficiency. Return on sales is equal to a firm's pre-tax income divided by total sales, measuring a firm's profit per dollar of sales (Bodie, Kane and Marcus 2002).

Cross sectional regression analysis, utilising the ordinary least squares method, was used to test the hypothesis that corporate social responsibility would improve the financial performance of an organisation. Our independent variable was corporate social responsibility with financial performance used as the dependent variable, controlling for size (total sales and total assets) and risk (ratio of long-term debt to total assets).

Results

Initially we regressed the entire data set as a whole in order to determine whether we would find an overarching relationship for the 277 companies. Preliminary results showed that the adoption of corporate social responsibility led to an increase in sales and an increase in equity. In comparison, the adoption of corporate social responsibility led to a reduction in return on assets. All results, however, were statistically insignificant and no reliable results could be obtained from these initial regressions.

Following these results, we split the data set into specific industries in order to determine whether this would have an impact on our results.⁴ While a number of results revealed potential relationships between the adoption of corporate social responsibility and a company's financial performance, none of the results were statistically significant.

4 Companies were split into their corresponding industries which included energy, materials, industrials, consumer discretionary, consumer staples, health care, financials, information technology, telecommunication services, utilities and property trusts.

Our inconclusive results on an industry basis may have been the result of our small sample size. After splitting our data into separate industries a number of tests included very few companies that had adopted corporate social responsibility. Also, some industries included only a very small number of companies in the first place, reducing the probability that we would receive a result that would be statistically significant.

Comment

In summary, our regression analysis on the majority of the ASX 300 companies did not reveal any statistically significant relationship between the adoption of corporate social responsibility and financial performance. However, in conducting the analysis a number of opportunities for refining the research were identified. As such, this paper could be considered as a first step in testing the relationship between financial performance and corporate social responsibility in the Australian context.

The over-riding research constraint we faced in conducting this analysis was the lack of a reliable measure of corporate social responsibility. Although assessing return on equity, return on assets and return on sales is relatively clear cut, the same cannot be said about assessing the extent to which corporate decision-making encompasses the social and environmental consequences of a course of action.

Our research has highlighted the need to develop better measures of corporate social responsibility within Australia. An increasing uptake of indices such as the Corporate Responsibility Index may assist in this regard. More reliable measurement of the extent to which a company has adopted corporate social responsibility will allow a more accurate analysis of the effect on financial performance.

There are a number of areas where future research in this area could proceed. Firstly, our analysis included most of the ASX 300 firms. Increasing our sample size, potentially the ASX 500, may allow for a better measure of the effect that the adoption of corporate social responsibility has on the financial performance of Australian companies. It may also be useful to determine whether significant relationships emerge and change as longer term financial information becomes available (Tsoutsoura 2004). The study period could be extended, and short-term and long-term measures of financial performance could be employed (Aupperle, Carroll and Hatfield 1985).

It may also be useful to use a one year lag between the measurement of financial performance and the corporate social responsibility measure to determine whether there may be a lag associated with the implementation of social responsibility and improved financial performance (Blackburn, Doran and Shrader 1994). Alternatively, a one year lag could be used to test whether better financial performance leads to an

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increase in the level of corporate social responsibility for an organisation (Waddock and Graves 1997).

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