

DOES FINANCIAL PERFORMANCE HAVE AN IMPACT ON CORPORATE SUSTAINABILITY AND CSR DISCLOSURE - A CASE OF CROATIAN COMPANIES

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Abstract

Purpose - The main objective of this research is to investigate the link between corporate sustainability and financial performance. The question of interest is why companies make voluntary CSR disclosure or, more precisely, is profitability possible determinant for CSR activities?

Design/Methodology/Approach - In order to test our hypothesis that financial performance increases the possibility that companies act socially responsible and disclose CSR reports we applied logistic regression analysis. The research is conducted on a sample of Croatian enterprises covering a period of nine years. Based on signalling theory, we expect that profitable companies have strong incentives to disclose information on social activities in order to enhance their competitive advantage and to avoid an incorrect assessment of their performance.

Findings - Results of the research confirm positive relation between sustainability concept of performance and financial result. Namely, companies with better financial performance and larger size companies are more aware of their corporate social performance and report on it.

Research limitations/implications - The study provides a starting point for further research on sustainability in developing and emerging markets.

Originality/value - This paper makes an important contribution to the knowledge of corporate social responsibility in developing countries like Croatia, which gradually accept the concept of sustainable performance. In contrast to developed countries, there has not been a sufficient amount of empirical research on the matter in these countries.

Keywords: sustainability, financial performance, Croatian enterprises.

1. INTRODUCTION

Corporate social responsibility (CSR)³⁵ is commonly associated with positive corporate virtues. It is understood to be the manner a company balances the economic, environmental and social aspects of its operations, addressing the expectations of its stakeholders and society-at-large. Although CSR is essentially

³⁵ Besides the term CSR another frequently used and related term is corporate social performance (CSP).

a very broad concept, it is based on a relatively simple idea that corporations have obligations to society that extend beyond mere profit-making activities (Godfrey & Hatch, 2007). From CSR point of view it is not only important what companies do with their profits, but also how they make them. In this regard, the concept of CSR is often used interchangeably with concepts of sustainable development, corporate citizenship, social enterprise, triple-bottom line, corporate ethics, and in some cases with corporate governance. Although companies may invest in social performance, the social reputation will be hard to achieve without proper disclosure of such information (Orlitzky, Schmidt and Rynes, 2003; Hasseldine, Salama and Toms, 2005). By disclosing on CSR activities companies are signalling that they are 'doing the right thing'. Signalling theory argues that the company gives signals to the shareholders and stakeholders in order to enhance its' value.

Even though the single bottom line in CSR context has become triple (i.e. economical, environmental and social), making a profit remains a fundamental concern for companies as it ensures their long term survival. Given the fact that the implementation of CSR is on voluntary basis, it can be questioned why some companies invest in CSR and other not? Does CSR increase profits, and if does not, why would companies invest in it anyway? Are social and economic goals compatible, and if not, is there a trade-off between these competing goals? Finally, if implementing CSR is a non-profit driven expenditure, how can it lead to profits? Notwithstanding extensive scientific research on this issue the link between CSR and corporate profitability still remains unclear. This is partly attributable to the differences in defining and measuring CSR and corporate profitability, as well as to differences in methodology being applied.

In this paper we analyse the possible link between CSR and corporate profitability in Croatia. We argue that different institutional settings can make differences in the degree of compatibility between corporate economic and social responsibility goals. Following the global trends, Croatian companies have been adopting the concept of social responsibility and international guidelines related to CSR activity reporting. The companies that have implemented the CSR concept are majorly members of the Croatian Business Council for Sustainable Development (CBCSD). However, the practice of adopting and reporting CSR activities is still rather modest and there is a need of better understanding the circumstances and effects of adopting CSR in Croatian institutional setting.

The remainder of the paper is organised as follows. Section 2 provides a brief literature review. Section 3 explains the sample selection, variable measurement and methodology applied. The results of the empirical research are presented and analysed in Section 4. Finally, the paper ends with Section 5 summarising the overall findings and with providing possible directions for future research on this subject.

2. THEORETICAL IMPLICATIONS AND LITERATURE REVIEW

Over the last 30 years substantial literature has been published on CSR, many containing different definitions of CSR and related concepts (Crane & Matten, 2004). The fuzziness of the concept and related research is well described by Carroll, one of the most prestigious scholars in the discipline (1994): "An eclectic field with loose boundaries, multiple memberships, and differing training/perspectives; broadly rather than focused, multidisciplinary; wide breadth; brings in a wider range of literature; and interdisciplinary."

Since a detailed review of this issue is beyond the scope of the study, the focus instead will be on two competing theories (Clarke, 1998; Lantos, 2001): neoclassical economic theory and stakeholder theory. The first theory describes the role of business in society in the purely economic profit making terms, focusing on the profit of the shareholders. The major proponent of this line of reasoning is Friedman (1970), arguing that: "the only one responsibility of business towards society is the maximisation of profits to the shareholders within the legal framework and the ethical custom of the country". However, the contemporary adherents of this theory (Sternberg, 1997; Barry, 2000; Jensen, 2001; Coelho, McLure and Spry, 2003; Sundaram and Inkpen, 2004; Henderson, 2005) consider shareholder value maximisation as the one of the objective function to all companies but are not necessarily against the social responsibility actions by companies. Moreover, some authors argue that CSR is often useful in generating a long-term shareholder value.

In the contrast, stakeholder theory is based on idea that companies have a social responsibility that requires them to consider interests of all parties affected by their actions. Donaldson and Preston (1995) explain that stakeholders are persons or groups with legitimate interests in procedural and/or substantive aspects of corporate activity. In this perspective, managers are not mere a shareholders' agents, rather they are builders of stakeholder relations (Rodriguez, Ricer and Sanchez, 2002). The introduction of stakeholder

theory allows these seemingly opposing views of management's responsibility to be combined (Freeman, 1984). Stakeholder theory places shareholders as one of the multiple stakeholder groups managers have to consider in their decision making process (Clarkson, 1995; Jones, 1995; Wood and Jones, 1995), while CSR is the strategy for dealing with stakeholders' demands. The shareholder perspective brings together social and economic aspects by considering a moral dimension of business. Carroll (1991) argues that the concept of stakeholder personalises social responsibilities by specifying groups or persons to whom companies are responsible and should be responsible.

Although there is an apparent difference between these two perspectives, the reason for a company to engage in CSR activities may reflect both aspects. Business that is not profitable has no future, and no CSR activities can be carried out without investing capital. On the other hand, while making a profit is critical for ensuring business continuity, it is not the one and only factor that can guarantee sustainability of the business. Therefore, it can be concluded that CSR seems to have a vague and complex impact on firm performance, and vice versa.

A special attention regarding the social performance is given to voluntary disclosure of such information. The sustainability reporting framework is usually based on three dimensions of performance widely known as the triple bottom line (TBL or 3BL) concept. The TBL reporting concept is driven from Elkington's call for an equal three part of approach (Elkington's 1997, 2001). This approach is base for current standards of the Global Reporting Initiative³⁶ and Integrated Reporting Framework where economic aspect of performing is still the main one. Voluntary disclosure is commonly explained by signalling theory. It argues that the most profitable companies provide the market with more and better information. The theory is based on information asymmetry between management and external parties. While management of the company has complete information about the company activities, shareholders and stakeholders lack the completeness of the information. Voluntary disclosure, therefore, signals the management's desire to disclose its superior performance to external parties, because it will enhance the reputation of the company and its position in the market. Based on that argument, we developed following hypothesis:

H1: Financial performance increases the possibility that company acts socially responsible and discloses CSR information.

While a number of research suggests that investment in CSR increases operating costs and makes the company less competitive (Friedman, 1970; Vance, 1975; Brummer, 1991; McWilliams and Siegel, 1997; Wright and Ferris, 1997; Moore, 2001; Jensen, 2002), other stream of research argues that through investing in social responsibility companies can achieve competitive advantage by attracting easily resources and high-quality employees, differentiating its products and services, reducing its exposure to risk, etc. (Cochran and Wood, 1984; Turban and Greening; 1996; Preston and O'Bannon, 1997; Waddock and Graves, 1997; Russo and Fouts, 1997; Ruf, Muralidhar, Brown, Janney and Paul, 2001; McWilliams and Siegel, 2001; Simpson and Kohers, 2002; Godfrey, 2004).

Margolis and Walsh (2003) have analysed 127 studies investigating the CSR/CSP and corporate financial performance (CFP) relation that were published during the period of 1972 to 2002.³⁷ In 109 of analysed studies CSR has been treated as an independent variable, predicting financial performance. The positive direction was reported in 54 studies, only 7 studies documented negative direction, 28 studies reported non-significant relationships, while 20 studies reported mixed set of findings. In 22 studies CSR has been treated as a dependent variable, predicted by financial performance. In these studies, the majority of results (16 studies) documented a positive direction, two studies found no significant relation and three studies reported mixed relationship. The mixed empirical evidence suggest that previously described differences in findings do not necessarily reflect mistakes or inaccuracies, but rather differences in perspective (observation periods, sample sizes and composition, measures of CSR and corporate performance, methodological approaches, institutional settings, mismatch between social and financial

³⁶ The GRI is a multi-stakeholder initiative intended to derive best practice guidelines for organisations wishing to report on voluntary basis (see www.globalreporting.org). Integrated Reporting Framework is an effort of IRRC to establish a basic structure that will be globally accepted as the corporate reporting norm. It combines sustainability and financial data to provide a holistic view of the company and its ability to sustain value over the short, medium and long term. (see www.theiirc.org).

³⁷ Four studies investigated the relationship in both directions but are counted only as one study. One study contains two separate studies and is therefore counted twice. That explains why there are more results than studies.

variables). It also suggests an empirical research broadening the scope of the analysis and integrating many of these considerations, may give us a more comprehensive picture of the effects of social responsibility on corporate performance.

For that reason the research on the link between CSR and financial performance in emerging countries like Croatia has valuable contribution to the broader perspective on CSR. This is especially due to social system in the past (i.e. from 1950 to 1991), when elements of the social behaviour of enterprises were incorporated in their performance. However, the issue of social responsibility as a new concept in the market economy and its impact on efficiency in the Croatian enterprises, and vice versa, has not been the subject of research or publications. In the past few years, corporate social responsibility and stakeholder approach were predominantly subject of theoretical and conceptual research in Croatia (Sisek, 2001; Krkač, 2007; Omazić, 2008; Vitezić, 2008; Tafra-Vlahović, 2009; Gregory and Tafra-Vlahović, 2010; Krkač, Volarević and Josipović, 2011), but rarely empirically investigating the economic causal aspects, particularly the relationship between enterprises financial performance (Vitezić, 2011) and CSR disclosure.

3. RESEARCH METHODOLOGY

In order to estimate the probability of CSR reporting we use sample of 42 companies, 22 large companies that report on CSR activities and 20 large companies that don't report on CSR activities. The companies are matched by industry. The companies that report on CSR are mainly drawn from CBCSD database. The financial data necessary for the research are extracted from annual financial reports database available at www.hanfa.hr, covering the period from 2002 to 2010. The final sample consists of total 345 company-year observations.

We used the existence of the corporate social disclosure as an indicator of CSR activity. CSR disclosure is often referred to as social disclosure, corporate social reporting, social accounting (Mathews, 1995) or corporate social responsibility (Hackston and Milne, 1996). Today companies disclose on their economical, environmental and social aspects of performance based on "triple bottom line" reporting system that is used mostly as a tool in order to demonstrate good citizenship. At the same time, this helps them to increase their revenue and profitability through enhanced reputation. The voluntary CSR disclosure indicates that company has a broader responsibility than merely looking for profits (Gray, Owen and Mandures, 1987), and a great deal of discussion on this issue is included in Integrated Reporting Framework (IIRC, 2012). Therefore, dependent variable (CSR) is referred to as CSR disclosure or CSR reporting. If company discloses on CSR activities the variable is equal to one, and zero otherwise. Since dependent variable is binary, we apply logistic regression analysis. The specification of the logit model is following:

$$\text{Prob(CSR)} = \beta_0 + \beta_1 \text{Profitability} + \beta_2 \ln \text{SIZE} + \beta_3 \text{OWN} + \varepsilon \quad (1)$$

The model is rather simplistic due to data availability problems, as there is no comprehensive database on CSR in Croatia. The variable description and measurement is given in the Table 1.

Table 1

Variable description		
Variable	Symbol	Description/Measurement
CSR disclosure	CSR	One if a company discloses on CSR and zero otherwise
Return on assets	ROA	Net profit / Average total assets
Return on equity	ROE	Net profit / Average equity
Size of company	lnSIZE	Nature logarithm of total asset
Type of ownership	OWN	One if foreign ownership and zero otherwise

The corporate financial performance is measured using accounting based variables: return on assets (ROA) and return on equity (ROE). The profitability ratios (ROA & ROE) are used separately to determine a company's financial performance. We used accounting-based measures since accounting returns reflect a company's internal efficiency rather than market fluctuations. Variable lnSIZE is a logarithmic transformation of total assets. It is included to control the differences in size of companies and in other omitted variables. It is expected that larger companies are more likely to be scrutinised by both the general public and socially sensitive special interest groups (Roberts, 1992). Moreover, they are mostly on stock

market and may have more shareholders and other stakeholders interested in corporate social activity and for that reason are more likely to use formal communication channels to relate results of social activities. Variable OWN represents the type of ownership structure (i.e. foreign and domestic) and it's used to control for differences in ownership structure.

Table 2

Descriptive statistic of variables			
Panel A: Continuous variables (n = 345)			
Variable	ROA	ROE	lnSIZE
Mean	0.0288	-0.0370	13.7861
Median	0.0211	0.0441	13.6501
Std. dev.	0.0847	1.4954	1.30459
Panel B: Categorical variables (n = 345)			
Variable	CSR	OWN	
Frequency	175	58	
Percentage	50.1%	16.8%	

Source: estimated according to data from authors' data base

4. ANALYSIS OF RESEARCH RESULTS

Analysis of the specified model was first performed by observing each variable separately (univariate approach), and then by observing all variables together (multivariate approach). Univariate analysis is used to examine characteristics of selected variables between two alternative groups, depending on whether companies that report on CSR activities or not. To test the difference between mean values of independent groups, we used both parametric t-test and the non-parametric Mann–Whitney U test. To test for significance of the relationship between categorical variables we used the Pearson Chi-square.

Table 3

Analysis of explanatory variables for alternative groups of CSR disclosure								
Panel A: Continuous variables								
Variable	CSR disclosure (n= 175)			Non CSR disclosure (n= 170)			t-stat.	z-stat.
	Mean	Median	St. Dev.	Mean	Median	Std. Dev.		
ROA	0.0562	0.0437	0.0727	0.0006	0.0077	0.0870	6.436 ^a	-7.595 ^a
ROE	0.1052	0.1014	0.1386	-0.1834	0.0177	2.1189	-1.798 ^c	-7.461 ^a
lnSIZE	14.540	14.388	1,2345	13.010	13.095	0.8377	13.428 ^a	-11.189 ^a
Panel B: Categorical variables								
Variable	Modality		CSR disclosure (n= 175)		Non CSR disclosure (n= 170)		Chi sq	
OWN	Yes		35 (20%)		23 (14%)		2.582	
	No		140 (80%)		147 (86 %)			

Notes: a, b, c means significant at 1%, 5%, 10% level respectively. Student t-statistics are adjusted for heterogeneity of variances when necessary.

Source: estimated according to data from authors' data base

Table 3 presents the results of the univariate analysis. The table highlights some basic differences between the companies that have CSR disclosure and companies that don't have CSR disclosure. The results show that companies that report on CSR activities are more profitable than companies that don't. The difference in mean values between groups of all continuous variables (ROA, ROE & ln SIZE) is significant at 1% level, while there is no statistically significant difference between groups based on ownership structure.

Although the univariate analysis gives some useful insights, logistic regression results facilitate the assessment of the incremental contribution of each variable in the CSR disclosure decision.

The results based on both models show that profitability increases the probability of CSR disclosure. The company size is also statistically significant determinant of CSR disclosure in both models, while ownership structure type is not statistically significant predicting variable.

The likelihood ratio chi-square of 180.31 for "Model 1" and 177.67 for "Model 2" with a p-value of 0.000 indicates that both models as a whole fit significantly better than an empty model. The calculated

multicollinearity tests suggest that collinearity is not serious issue in both samples (i.e. variance inflation factors are lower than 5, and tolerance factors are higher than 20%). Although the strength of association is not so strong (pseudo R square is 38% for “Model 1” and 37% for “Model 2”), area under ROC curve signifies that the discriminating power of both models is good. A percentage of overall correct classification is almost identical in both samples.

Table 4

Logistic regression on CSR disclosure				
Independent variable	Model 1		Model 2	
	Coeff.	z-value	Coeff.	z-value
Intercept	-22.5413	-8.38 ^a	-22.7086	-8.40 ^a
ROA	11.5373	4.46 ^a	-	-
ROE	-	-	4.9182	4.13 ^a
lnSIZE	1.5889	8.32 ^a	1.6230	8.42 ^a
OWN	0.4922	1.19	0.2127	0.55
LR chi ² (3)		180.31 ^a		177.67 ^a
Pseudo R sq		0.3771		0.3715
Area under ROC curve		0.8830		0.8814
Correctly classified		79.42%		80%
Sample size		345		345

Notes: a, b, c means significant at 1%, 5%, 10% level respectively.

Source: estimated according to data from authors' data base

5. CONCLUDING REMARKS

Corporate social responsibility has been mostly analysed from the aspects of economy benefits that a company has from its social orientation, because financial aspects of the performance will always dominate in market economy as bottom line. However, corporate social responsibility and sustainability as a broader concept includes a whole number of responsiveness actions that companies make to demonstrate their positive policies toward environmental and social issues beyond merely economical. It is determined by management and owner attitudes towards the social aspects of the performance by respecting the interests of all stakeholders. It doesn't matter if CSR is sometimes attributed as PR invention only or as a new way to gain profitability, the idea of sustainable development is valuable and needs to be promoted as a way of doing business in future since in its very essence it is an ethical concept. Finally, the benefits that companies and society could have from applying this concept would overcome invested costs at the long run.

Although many researchers have found positive relationship between CSR and financial performance so far, still there is a challenge how to estimate quantitatively that impact. For that reason our study has an aim to investigate if financial performance of Croatian companies enables them to disclose about corporate social responsibility. In last decade it is recognised that companies more disclose on that issue. They are many reasons: improved image and reputation, revenue increases, higher profitability, employee motivation, cost savings etc. In our research profitability is measured by standard indicators ROA and ROE. Using logistic regression we found that profitability and size of the company increase the possibility to of acting socially responsible. Companies, mostly the large one that have higher profitability, have more willingness to disclose on their social and environmental business acting and strategy.

However, the analysis in this paper is limited in several ways and many other aspects of the issue can be investigated in the future. Firstly, it would be interesting to extend the research by including other emerging countries and by adding variables that are not only related to financial performance, but also represent cultural, regulatory and governance aspects that may have impact on the development and nature of corporate social responsibility. Also, our measurement of CSR is rather simplistic and it could be improved by using questionnaires and constructing disclosure indexes. Finally, the contribution can be made by applying better methodological solutions that account for individual unobserved heterogeneity and other forms of endogeneity, which is important and widespread problem in economic research generally.

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