Original Article

Assessing the long-term financial performance of ethical companies

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ABSTRACT With the increased importance of corporate social responsibility (CSR), its impact on a firm's financial performance has been investigated in the marketing/finance interface. Prior research has found that CSR is positively related to firm market value, but most efforts have been focused on examining the relationship between CSR and short-term financial performance. Motivated by this research gap, this study attempts to uncover CSR's long-term financial performance using archival data on composite CSR scores and individual CSR dimensions. The results show that CSR is negatively related to a firm's systematic and unsystematic risks, suggesting that once recognized as ethical company, a firm can reduce its risks. Of the eight CSR dimensions, 'Community' and 'Employee Relationship' can be seen to lower systematic risk, whereas 'Product/Customer' and 'Employee Relationship' are the main drivers that enhance a firm's idiosyncratic return.

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INTRODUCTION

In recent years, since there has been a call for more financial accountability in marketing, many scholars have focused on the marketing/finance interface.¹ In fact, most research efforts have been focused on investigating the relationship between marketing variables and actual financial performance. The research framework for the marketing/finance interface is represented from a dynamic perspective.²

Among those marketing capabilities and actions that might allow high financial performance, the

field of corporate social responsibility (CSR) has grown exponentially in the last decade. A larger number of companies than at any previous time are engaged in an intensive effort to define and integrate CSR into all aspects of their business areas. An increasing number of shareholders, analysts, regulators, activists, labor unions, employees, community organizations and news media have started to ask companies to be responsible for an ever-changing set of CSR issues. Accordingly, there is increasing demand for transparency, and growing expectations that corporations measure, report and continuously improve their social, environmental and economic performance.^{3–5}

Although adopting CSR principles involves cost, this cost might be short-term in nature or

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take the form of continuous outflows.³ Companies perceived to have a strong CSR commitment often have an increased ability to attract and retain employees.⁶ Recently, the relationship between CSR and the market value of a firm have been addressed using the marketing/finance perspective. According to this research, CSR affects market value partially through the mediator of customer satisfaction, and returns to CSR can be both positive and negative, depending on the level of the firm's capabilities.⁷

A 1-year lagged performance of CSR is a common measure for CSR impact on market value, but the extended financial performance of CSR has not been investigated on a long-term basis. Motivated by this research gap, this article examines the relationship between CSR and a firm's financial performance on a long-term basis. In addition, this article provides the evidence that CSR is related to higher long-term-based financial performance, and investigates the association between CSR and a firm's idiosyncratic returns, as well as between CSR and systematic risks.

MODEL DEVELOPMENT

Srivastava *et al.*⁸ developed a conceptual framework that makes explicit the contribution of marketing to shareholder value. In addition, they advanced the notion of market-based assets as a principal bridge between marketing and shareholder value and provided rationale and justification logic for marketing's contribution to financial performance improvement. Potential measures of financial performance created by marketing are offered for future empirical study. Srinivasan and Hanssens⁹ proposed that marketing can create shareholder value by including the impact of brand equity, customer equity, customer satisfaction, R&D and product equity, and specific marketing-mix actions on forms value.

As mentioned, CSR has been considered to have positive impact on a firm's performance. According to Business for Social Responsibility, CSR is defined as 'achieving commercial success in ways that honor ethical values and respect

people, communities, and the natural environment'. In addition, CSR can be defined as 'actions that appear to further some social good, beyond the interest of the firm and that which is required by law', indicating that CSR goes beyond just following the law.¹⁰ Given that a socially responsible corporation should take a step forward and adopt policies and business practices that go beyond the minimum legal requirements and contribute to the welfare of its key stakeholders, CSR can be described as 'an action by a firm, which the firm chooses to take, that substantially affects an identifiable social stakeholder's welfare'. Figure 1 displays research framework that makes it possible to address the relationship between CSR and a firm's financial performance on a long-term basis.

CSR and its long-term financial performance

As addressed in the prior research, CSR seems to have a positive impact on a firm's financial performance, although there has been controversy regarding CSR's effect. The basic underlying assumptions are that CSR is positively related to a firm's financial performance, and that being socially responsible might create a favorable company image and brand image.^{7,11–14} However, CSR is a long-term, rather than short-term, investment, suggesting that CSR's impact on financial performance should be addressed within a wider time frame. One- or two-year lagged financial performance is not sufficient to wholly grasp the long-time financial performance implications of CSR. Given that it would take more than 1 year to transfer CSR to actual financial outcome, at least 3–5 years' cumulative effect of CSR should be investigated using financial market dynamics.

Moderating factor and control variables

CEO compensation appears to have a moderating effect on the association between CSR and firm value, because consumers and investors may think CEO compensation that is too high or too low is not appropriate, indicating that CSR is not credible. Each company differs

Figure 1: Research framework.

in how it implements CSR, if it implements it at all. The differences depend on such factors as the specific company's size, the particular industry involved, the firm's business culture, stakeholder demands and how historically progressive the company is in engaging in CSR. Some companies focus on a single area that is regarded as the most important for them, or where they have the highest impact or vulnerability – human rights, for example, or the environment – while others aim to integrate CSR into all aspects of their operations. For successful implementation, it is crucial that the CSR principles are part of the corporation's values and strategic planning, and that both management and employees are committed to them. Furthermore, it is important that the CSR strategy is aligned with the company's specific corporate objectives and core competencies.³ Therefore, firm size and type of industry should be controlled in investigating the relationship between CSR and its financial outcome.

RESEARCH SETTING AND DATA DESCRIPTION

To examine the association between CSR and long-term financial performance, this article defines and measures independent variables, dependent variables, moderating variables and control variables, as seen in Table 1.

Variables definition

CSR is viewed as a comprehensive set of policies, practices and programs that are integrated into business operations, supply chains and decision-making processes throughout the company, and usually include issues related to business ethics, community investment, environmental concerns, governance, human rights and the marketplace, as well as the workplace.¹⁵ According to Friedman,¹⁶ in a free society, '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 within the rules of the game, which is to say, engages in open and free competition without deception or fraud'.

CSR can be measured using existing resources, such as *Fortune's* America's Most Admired Company (FAMA), the Business Ethics Score published by *Business Ethics*, the FTSE4Good Index and the KLD index. This study uses the 100 Best Corporate Citizens list from *Business Ethics* for CSR measurement from 2000 to 2006. Prior research regards FAMA as a more reliable data source.^{7,17} The *Business Ethics* 100 Best Corporate Citizens list is also credible, and is composed based on a variety CSR activities. As the *Business Ethics* 100 Best Corporate Citizens list was developed and first published in 2000, it has gained national recognition as an indicator of best practices in the

Table 1: Data description

Variable	Measure	Operationalization	Data source
Independent variable	CSR	Composite Score of CSR	The <i>Business Ethics</i> 100 Best Corporate Citizens
	Individual dimension	Community (Comm), Corporate Governance (Gov), Diversity (Diver), Employee Relationship (Empl), Environment (Envir), Human Rights (Hright), Product/Consumer (Cust)	The <i>Business Ethics</i> 100 Best Corporate Citizens
Moderator	CEO compensation (CEO)	Ln (Salary + Bonus)	COMPUSTAT
Dependent variables	Firm's idiosyncratic return (FIR)	Stock returns explained by firm-specific characteristics	CRSP
	Systematic risk (Beta)	Stock risks explained by the market	CRSP
	Idiosyncratic risks (IdioR)	Stock risks explained by firm-specific characteristics	CRSP
	Stock returns (ACCSRet)	Holding period returns	CRSP
	Total risks (TotRisk)	Standard deviation of stock returns	CRSP
Control variables	Sales (Sales)	Ln(Sales)	COMPUSTAT
	Total assets (Tasset)	Ln(Total Asset)	COMPUSTAT
	Number of employees (Nempl)	Ln(Number of Employee)	COMPUSTAT
	Value of common stock (Stock)	(DATA24×DATA25×1000)	COMPUSTAT
	Total senior securities (TSS)	DATA5 + DATA9 + DATA10	COMPUSTAT

area of CSR, and is regarded as the third most influential corporate ranking, behind Fortune magazine's 'Most Admired Companies' and '100 Best Companies to Work For', according to a PRWeek/Burson-Marsteller CEO Survey.¹⁵

In this study, five dependent variables are taken into account: firm's idiosyncratic returns (FIR), stock returns explained by firm-specific characteristics;⁷ systematic risks (Beta), stock risks explained by the market; idiosyncratic risks (IdioR), stock risks explained by firm-specific characteristics; stock return (ACCSRet), holding period returns; and total risks (TotRisk), standard deviation of stock returns.¹⁸ The 100 companies' monthly holding period returns were computed based on The Center for Research in Security Prices (CRSP) data and market data on the website of Dr Kenneth French.¹⁹

The moderating variable is CEO compensation from COMPUSTAT. The five control variables, including total assets, number of employees, sales, market value of common stock, and total senior securities were also extracted from COMPUSTAT.

Data merge

There is a 2-year time lag between actual data and announcing data. For example, if the CSR score is announced in 2000 in the *Business Ethics*

100 Best Corporate Citizens, it contains a 3-year average of CSR from 1996 to 1998. Therefore, in order to employ longitudinal data analysis, dependent variables are taken into account during each three-consecutive-year period immediately after actual data ends.

Given this, data announced in 2000 include the average CSR of 1996, 1997 and 1998, and data on dependent variables range from 1999 to 2005 with five time frames. Table 2 shows each panel's actual data and time frames for the 28 dependent variables. The analysis includes a total of 277 observations of CSR with a 2-year time lag available from (1996–1998: 2000 Announcement) to (2002–2004: 2006 Announcement).

Methods

Using the Fama–French Four Factors Model, five dependent variables were calculated:²⁰

$$R = a + b1 RMRF + b2 SMB + b3 HML + b4 UMD + error$$

where *RMRF* is market factor; *SMB* is size factor; *HML* is value factor; *UMD* is momentum factor.

In this regression equation, *a*, the intercept is firm-idiosyncratic return and *b1* is firm's

Table 2: Data time frame

	<i>Actual data</i>	<i>Announced</i>	<i>t1</i>	<i>t2</i>	<i>t3</i>	<i>t4</i>	<i>t5</i>	<i>t6</i>	<i>t7</i>
PANEL1	1996–1998	2000	1999–2001	2000–2002	2001–2003	2002–2004	2003–2005	2004–2006	2005–2007
PANEL2	1997–1999	2001	2000–2002	2001–2003	2002–2004	2003–2005	2004–2006	2005–2007	—
PANEL3	1998–2000	2002	2001–2003	2002–2004	2003–2005	2004–2006	2005–2007	—	—
PANEL4	1999–2001	2003	2002–2004	2003–2005	2004–2006	2005–2007	—	—	—
PANEL5	2000–2002	2004	2003–2005	2004–2006	2005–2007	—	—	—	—
PANEL6	2001–2003	2005	2004–2006	2005–2007	—	—	—	—	—
PANEL7	2002–2004	2006	2005–2007	—	—	—	—	—	—

systematic risk. Firm-idiosyncratic stock returns is the expected excessive firm-specific cash flows relative to the average market portfolio returns of stock exchanges, such as the New York Stock Exchange or the American Stock Exchange. The firm-idiosyncratic return is driven by micro, firm-level factors, such as marketing strategies whereas market-wide return is influenced by other macroeconomic factors, such as interest rates and inflation shocks in the country.

The beta coefficient is a measure of *volatility* of a stock in relation to the rest of the *financial market*. If beta of an asset is 0, its price is not at all correlated with the market, suggesting that asset is independent with market. A positive beta means that the asset generally follows the market, but a negative beta shows that the asset inversely follows the market, indicating that the asset generally decreases in value if the market goes up.

Firm's idiosyncratic risk is sum of residuals that are differences between actual return and estimated return. Computation of holding period return and total risk is based on compustat database. Then, impacts of composite CSR and each dimension are given according to multivariate regression. Then, impacts of composite CSR and each dimension are given according to multivariate regression.

$$\begin{aligned}
 FIR_{t+1} = & a + b1 CSR_t + b2 Comm_t + b3 Gov_t \\
 & + b4 Diver_t + b5 Empl_t + b6 Envir_t \\
 & + b7 Hright_t + b8 Cust_t + b9 CEO_t \\
 & + b10 CEO_t \times CSR_t + b11 Sales_t \\
 & + b12 Tasset_t + b13 Nempl_t \\
 & + b14 Stock_t + b2 TSS_t
 \end{aligned}$$

$$\begin{aligned}
 Beta_{t+1} = & a + b1 CSR_t + b2 Comm_t + b3 Gov_t \\
 & + b4 Diver_t + b5 Empl_t + b6 Envir_t \\
 & + b7 Hright_t + b8 Cust_t + b9 CEO_t \\
 & + b10 CEO_t \times CSR_t + b11 Sales_t \\
 & + b12 Tasset_t + b13 Nempl_t \\
 & + b14 Stock_t + b2 TSS_t
 \end{aligned}$$

$$\begin{aligned}
 IdioR_{t+1} = & a + b1 CSR_t + b2 Comm_t + b3 Gov_t \\
 & + b4 Diver_t + b5 Empl_t + b6 Envir_t \\
 & + b7 Hright_t + b8 Cust_t + b9 CEO_t \\
 & + b10 CEO_t \times CSR_t + b11 Sales_t \\
 & + b12 Tasset_t + b13 Nempl_t \\
 & + b14 Stock_t + b2 TSS_t
 \end{aligned}$$

$$\begin{aligned}
 ACCSR_{t+1} = & a + b1 CSR_t + b2 Comm_t + b3 Gov_t \\
 & + b4 Diver_t + b5 Empl_t + b6 Envir_t \\
 & + b7 Hright_t + b8 Cust_t + b9 CEO_t \\
 & + b10 CEO_t \times CSR_t + b11 Sales_t \\
 & + b12 Tasset_t + b13 Nempl_t \\
 & + b14 Stock_t + b2 TSS_t
 \end{aligned}$$

$$\begin{aligned}
 TotRisk_{t+1} = & a + b1 CSR_t + b2 Comm_t + b3 Gov_t \\
 & + b4 Diver_t + b5 Empl_t + b6 Envir_t \\
 & + b7 Hright_t + b8 Cust_t + b9 CEO_t \\
 & + b10 CEO_t \times CSR_t + b11 Sales_t \\
 & + b12 Tasset_t + b13 Nempl_t \\
 & + b14 Stock_t + b2 TSS_t
 \end{aligned}$$

RESULT AND DISCUSSION

The analysis in this application consists of three steps, as mentioned earlier. First, to obtain

Figure 2: Coefficient of CSR over time.

cumulative FIR and beta for each time frame, almost 10000 iterations of regression were conducted. The same amount of regression tasks was repeated to investigate the association between CSR and other financial performance measures. Figure 2 displays the coefficient estimates of CSR on each financial performance measures.

The significant negative effects of CSR on FIR are found in Panels 2 and 3, whereas in Panel 5, there are positive impacts of CSR on FIR, indicating that it is somewhat ambiguous whether CSR has a positive impact on FIR. However, the negative impact of CSR is found right after social responsibility scores are announced, but the positive impact appears within a 1- or 2-year time lag. After a 3-year time lag, this CSR impact starts to disappear, which means it takes some time for CSR have an effect on financial performance.

Interestingly, not all dimensions have the same impact on financial outcome. Community concern is negatively associated with a firm's idiosyncratic return in Panel 1, but positively in Panel 5. There is no consistent effect of CSR on FIR, but CSR cannot prompt increased FIR right after social investment. In addition, positive interaction between CSR and CEO compensation is significant in one cell, which means that the CEO can be motivated by the firm's long-term investment. As a result, coefficient estimates for CSR have meaningful directions toward dependent variables over time. The impact of composite CSR on FIR is somewhat confusing, but generally, CSR tends to increase the FIR with time lag over time.

At the outset of this research, it was assumed that CSR could lower systematic risks. The results show that the negative impacts of CSR on beta are identified many times, although there are also positive coefficients. Specifically, each component of CSR is negatively related to systematic risk, indicating that social investment can reduce firm risk explained by the market. Given the immediate effect of CSR components, CSR has influential power to lower the market risk. Accordingly, CSR tends to impact on beta shortly after social investment. The effect of

composite CSR on FIR is relatively negative except for one panel, showing that CSR is expected to lower systematic risks.

Although CSR has mixed effects on a firm's idiosyncratic risk, it is obvious that CSR might lower the firm's specific risk not explained by the market. In Panels 1 and 2, it is seen that it takes time for CSR to affect idiosyncratic risk, but in Panels 3 and 5, the negative impact of CSR on firm's risk is seen spread out over time. The results indicate that the association between CSR and idiosyncratic risk is by and large unclear, meaning that CSR is not expected to decrease a firm's idiosyncratic risk.

In Panels 2 and 4, there is clear, immediate, positive impact of each component of CSR on holding period return, whereas composite CSR has a long-term effect with a 2- or 3-year time lag in Panels 4 and 5. This may be because social investment can create a favorable firm image, making the firm more valued in the stock market. Given that the effect of CSR on holding period return is increasing over time, CSR might increase favorability in investors' and consumers' minds.

CSR impact is clearer when the dependent variable is total risk than when any other dependent variables are used. Analysis results show that all CSR components have negative impacts on total risk in Panel 2. However, composite CSR is significant in several cells, but its sign is positive, indicating that CSR cannot lower total risks in the short term.

As seen in Figure 3, each CSR component is negatively related to risk, including systematic and unsystematic risk. Some components have positive impact, but, generally, there are negative association between CSR components and risk. This can be attributed that each CSR dimension might lower uncertainty owing to being a good citizen in society. Once recognized as a good corporate citizen, a firm can reduce its risk influenced by market and the firm itself at the same time. In particular, Community and Employee Relationship can lower systematic risk. The results also display coefficient estimates of each individual CSR dimension, indicating that Product/Customer and Employee Relationship

Figure 3: The impact of CSR dimensions on beta and idiosyncratic return.

are main drivers that enhance a firm's idiosyncratic return.

CONCLUSION

As CSR has recently received much attention from marketing scholars and practitioners, CSR's impact on firms' financial performance has been investigated in the marketing/finance interface. Prior research found that CSR is positively related to firm market value. However, most research efforts have been focused on examining the relationship between CSR and relatively short-term financial performance. Motivated by this research gap, this study attempts to uncover CSR's long-term performance using archival data on composite CSR scores and eight CSR dimensions. This article fails to find consistent CSR impact on financial outcome, but it

provides the meaningful result that CSR is negatively related to systematic and unsystematic risks.

Summary

This research addresses CSR's impact on financial performance by using composite CSR and its dimensions. The results show that CSR's long-term effect on financial performance is not fully supported, but it is supported in part by panel data. Interestingly, interaction between CSR and CEO compensation was found in several cases. Further, the study focused on the impacts of CSR dimensions on the financial outcome. Among eight CSR dimensions, Diversity and Minority Concerns are negatively associated with the financial outcome in several cases. However, Employee Relationship and Environment have a

positive impact on the financial performance in many cases.

Managerial implications

Managements should vigilantly ensure that there is no trade-off between CSR aims and financial performance after making a social investment. The CEO should prioritize long-term social investments and uphold social responsibility to ensure sound financial performance in the future.

A new challenge for marketing managers lies in identifying the market-based assets they currently possess and harmonizing them to improve the financial outcome. Companies should simultaneously seek to maximize profits and shareholder value – goals that will be impossible to achieve until marketing managers successfully identify these assets. For successful implementation, it is crucial that the CSR principles be integrated into company values and strategic planning, and that both management and employees be committed to them. Furthermore, it is important to align the CSR strategy with specific corporate objectives and core competencies.³

Finally, CSR provides useful information that investors can benefit from in making investment decisions. Hence, investors should monitor not only prior stock market performance but also companies' social responsibility.¹⁷

Theoretical implications

Theoretically, the analysis shows that CSR can improve firms' favorable image and familiarity with a longitudinal approach, increasing their financial performance; further, the analysis highlights that each CSR component has a different impact on firms' financial performance. Mizik and Jacobson²¹ assess which brand asset metrics of the five pillars provide incremental information content to accounting performance measures in explaining stock returns. Drawing on their research, the author attempts to apply various dimensions of CSR to address the more dynamic relationship between CSR and financial performance.

Unlike prior research, the author finds that merely having high overall CSR scores cannot

guarantee a firm financial success, and thus, this article seeks to explain the complicated relationship between CSR and financial performance using composite CSR scores and eight CSR dimensions simultaneously. In addition, this study diversifies financial performances with five dependent variables, including FIR, beta, idiosyncratic risk, stock returns and total risks.

The results show that a high composite CSR score alone cannot guarantee short-term financial success for firms, but can enhance their long-term stock market valuation. Further, the analysis indicates that CSR can improve firms' financial performance, highlighting that each CSR component differently impacts financial performance. The theoretical premise is that marketing activities create financial value. Basically, marketing involves the task of developing and managing market-based assets, which include customer relationships, channel relationships and partner relationships. These assets influence shareholder value by accelerating and augmenting cash flows, while reducing the risks and increasing their value.⁸ This study indicates that CSR can be considered as a market-based asset.

Future directions

This study examines the long-term financial impact of CSR using panel data but it has several weaknesses in terms of methodology, dependent variable and moderating variables. First, in order to investigate the dynamic impact of CSR on financial performance, structural equation model can be used for more comprehensive modeling from CSR to firm's market valuation. An event study could be also conducted regarding the impact of an announcement of a firm's large social investment (scholarship, donation, charity and sponsorship). In addition, future research should address CSR with wider data for a comprehensive longitudinal approach.

Second, analysts' forecasts can be employed as alternative dependent variables, apart from the five variables used in this analysis. As firm valuation can be influenced by CSR, analysts forecast can be influenced by CSR. Given this,

analysts' forecast can be considered as a bridge between CSR and firm valuation.

Third, more moderating variables are needed. Consumers' attributions of corporate outcomes in response to CSR can influence the financial performance of CSR.²² Many empirical studies have tried to reveal the relationship between customer satisfaction and real profit.^{23–25} Previous studies also indicate that customer satisfaction is expected to mediate the relationship between CSR and market value.⁷ This result can be attributed to customer satisfaction, which makes it possible to convert CSR into financial value. Even though customer satisfaction is a cumulative concept during the relatively long term rather than the short term, CSR can create a positive response in customer satisfaction. Accordingly, consumers can perceive high level of ethics, facilitating favorable evaluation and satisfaction. Brand equity can moderate the relationship between CSR and its financial output.²⁶ In addition, R&D costs could be included as a moderation variable that can interact with CSR, affecting its financial outcome.¹⁰

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