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# Impact of Positive and Negative Corporate Social Responsibility on Corporate Financial Performance and Idiosyncratic Risk

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## Abstract

Despite growing interest for corporate social responsibility (CSR) in the literature, the relationship between CSR activities and idiosyncratic risk of firms, one of the critical components in evaluating shareholder value, has been a topic of scarce examination. Further, the moderating role of firm size on the link between CSR and idiosyncratic risk has not been studied. Existing research on the financial implications of CSR for firms has predominantly focused on positive aspects of CSR, over-looking that companies also undertake actions and initiatives that qualify as corporate social irresponsibility or negative CSR. This study dichotomizes CSR activities into two dimensions, socially responsible activities (positive CSR) and socially irresponsible activities (negative CSR), to scrutinize the distinct effects of the two extents. The authors demonstrate how positive and negative CSR can influence corporate financial performance (CFP) and idiosyncratic risk of firms and discuss the role of firm size as a moderator in the relationship. The proposed hypothesis for the framework and its theoretical justification are discussed in this paper.

**Keywords:** Positive corporate social responsibility, negative corporate social responsibility, corporate financial performance, idiosyncratic risk

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## 1. INTRODUCTION

In current years, CSR has emerged as a dominant theme in the competitive business world. As CSR becomes a pivotal mainstream business activity, it is being endorsed as a core area of management, next to marketing, accounting, or finance (Crane 2008). In response to the growing popularity of CSR in practice, there is a growing multidisciplinary literature on CSR and its impact on firm actions and outcomes. A large number of studies have investigated the link between CSR and CFP (e.g., Margolis & Walsh 2001; 2003; Peloza 2009; Kim et al. 2015; Park et al. 2014). Even though the relationship between CSR and CFP has been a central and contentious argument in the literature, previous empirical studies provide indefinite conclusions. Prior empirical studies provided indefinite conclusions result has been shown by any direct correlation between CSR and CFP (Kim et al. 2015; Cornett et al. 2016; Kapoor & Sandhu 2010; Oh & Park 2015; Zhao & Murrell 2016; Waddock & Graves 1997). Although a considerable body of research has addressed the empirical relation between CSR initiative and CFP in numerous industries, nevertheless only limited evidence of the impact of CSR on firm risk (Hsu & Chen 2015; Bouslah et al. 2016; Bouslah et al. 2013) and the observed association between CSR and firm risk following remains in its infant stage (Jo & Harjoto, 2014). Therefore, the association between CSR and firm risk is an empirical issue and demands for further investigation (Hsu & Chen 2015).

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Specifically, with the present of firm size as moderator and research measuring the separate effects of positive and negative CSR initiatives on companies' financial performances remains, as yet, unconsidered (Kang et al. 2010).

The effect of CSR on firm risk is an interesting topic. In recent years, both in academia and practitioners around the world studied the impact of CSR engagement on firm risk (Becchetti et al. 2015; Branzei et al. 2016; Kim & Kim 2014; Rahman & Post 2012). Although there have been studies examining the relationship between CSR and systematic risk, however, studies examining the influence of CSR on idiosyncratic risk has been overlooked. Idiosyncratic risk accounts for approximately "80 % of total stock risk and security price fluctuations" (Bansal & Clelland 2004, p. 94) and investors set a lower cost of capital for firms with a lower risk (Shin & Stulz 2000). In general, risk management can reduce firm risk by reducing the probabilities of expected financial, social, or environmental crisis that could influence adversely firm's cash flows (Sharfman & Fernando 2008) and/or by generating moral capital or goodwill which can provide "insurance-like" protection to preserve financial performance (Godfrey et al. 2009; Godfrey 2005). It is expected that the CSR activities of the firm can reduce idiosyncratic risk as stated by Mishra and Modi (2013) and Bouslah et al. (2016). The objective of this study is to propose a framework that relates the positive and negative CSR, idiosyncratic risk and firm size.

## **2. LITERATURE REVIEW**

### **2.1 Corporate Social Responsibility**

McWilliams and Siegel (2001) define CSR as "actions that appear to further some social good, beyond the interests of the firm and that which is required by law" (p. 17). Thus, CSR measures include a broad range of CSR activities such as support for local businesses or charities, corporate firm reputation, social engagement, environmental responsibility, brand perception, ethics, product quality, and sustainability (Margolis & Walsh 2001). Investing in CSR potentially provide financial benefits to firms, reduce firm risk, and be associated with better long-run growth prospects (Gregory et al. 2014), for instance, firms which reduce waste avoid environmental disasters/lawsuits/consumer boycotts, and thus enjoy an increase in brand value and reputation, increased motivation among employees, and improved customer attraction and retention.

### **2.2 Positive Corporate Social Responsibility (PCSR) and Negative Social Responsibility (NCSR)**

Current research on the financial implications of CSR for firms has mainly focused on positive aspects of CSR (e.g., Kotler & Lee 2005; Luo & Bhattacharya 2009; Porter & Kramer 2007) that firms also practice unsocially actions and initiatives that qualify as negative CSR which lower societal welfare (Bird et al. 2007). However, empirical studies in the CSR literature have not investigated how both positive and negative CSR affect both CFP and idiosyncratic risk. According to Heal (2005), Positive CSR or PCSR is a program of actions to reduce externalized costs or to avoid distributional conflicts. Heal (2005) defines, PCSR can be interpreted as a Coasian solution to problems associated with social costs (Kotchen & Moon 2012). On the other hand, corporate social irresponsibility or NCSR is a set of actions that increases externalized costs and promotes distributional conflicts (Kotchen & Moon 2012). Bird et al. (2007) investigated relationships between firms' positive and negative CSR activities for each stakeholder group and equity performance, measured by the market to book and price to earnings ratio. They reported different directions and magnitudes for each (i.e., positive and negative) CSR activity's impact on firm performance. Therefore, ignoring negative CSR can lead to an incomplete picture of the financial implications of CSR for firms (Mishra & Modi 2013) because based on differently weighted perceptions for positive or negative information in a certain condition, the likelihood of an asymmetric impression exists for a firm's positive and negative CSR activities.

### **2.3 The Relationship between Corporate Social Responsibility and Corporate Financial Performance**

The relationship between CSR–CFP has extensively studied by researchers (e.g., Endrikat et al. 2014; Orlitzky et al. 2003). However, there is a discrepancy in the outcomes due to the differences in the theoretical and methodological frameworks (e.g., Preston & O'Bannon 1997; Waddock & Graves 1997; Surroca et al. 2010). Various hypotheses have sought to explain the link between CSR and CFP. The main findings of these studies are controversial as they offer conceptual interpretations for a positive, neutral and negative relationship between CSR and financial performance (Preston & O'Bannon 1997; Waddock & Graves 1997). While some studies have provided evidence of a positive relationship (e.g., Belghitar et al. 2014; Kim et al. 2015; Reverte et al. 2016; Cornett et al. 2016; McGuire et al. 1988), others have supported the conclusion of a negative relationship (e.g., Kapoor & Sandhu 2010; Adhikari 2016; Hassel et al. 2005) or yielded insignificant results (e.g., Waddock & Graves 1997).

The stakeholder theory could explain the relationship between CSR and CFP (Porter et al. 2007; Jones 1995; Mcguire et al. 1988). Based on the theory, the value of a company is related to the cost of both explicit and implicit claims on a company's resources. The theory (Freeman, 1984), suggests that firms expand the possibility of consideration in their decision-making and actions beyond shareholders to more than a few other constituencies with welfares, such as customers, employees, suppliers and communities. Waddock and Graves (1997) argue that the benefits from CSR are greater in comparison with its costs. Therefore, there should be a positive association between CSR and CFP. Preston and O'Bannon (1997) argue that meeting the needs of various corporate stakeholders enhances a firm's reputation in a way that will have a positive impact on its CFP. A company's ability to sense and respond strategically to opportunities and threats enhances competitive advantage (Li & Liu 2014). Because of CSR involves continually evaluating corporate influences and relationships with stakeholders and the environment, CSR enables management to identify and respond to evolving strategic opportunities and challenges. For specific CSR programs, Porter and Kramer (2006) identified this as double effect shared value. CSR's positive effect on financial performance is a result of greater competitive advantage and reputation (Saeidi et al. 2015). In conclusion, implementing CSR can improve corporate social and financial performance (Mirvis et al. 2016). By contrast, an irresponsible corporate action or NCSR may be negatively associated with CFP because the immoral or negligent actions of the firm will tarnish its business reputation and destroy relationships with numerous stakeholders (Armstrong & Green 2013). Specifically, NCSR endangers consumer disfavour, protests by activist groups, and negative media coverage (Barnett L & Salomon 2006). Thus, resulting in NCSR is a degradation of a firm's reputation. In addition to a decline in reputation, NCSR is likely to harm stakeholder relationships because it is a "bad" deed of a business that reduces stakeholder value (Mena et al. 2016), subsequently affect CFP. Therefore, it is proposed that:

H1a: A positive relationship exists between PCSR and CFP.

H1b: A negative relationship exists between NCSR and CFP.

#### **2.4 The Relationship between Corporate Social Responsibility and Idiosyncratic Risk**

Business operations may benefit a company's stock returns, but at the same time, they may also increase firm risk. Unfortunately, researches on CSR and Idiosyncratic risk have not been extensively carried out. A study which emphasises only stock returns or other typical firms' performance measures, such as Tobin's Q and return on assets (ROA), may yield an incomplete and constrained viewpoint in understanding the full effect of CSR activities on the shareholder value – firm risk relationship (Kim & Kim 2014; Luo & Bhattacharya 2009). The capital asset pricing model suggests that a company's total risk consists of two kinds of risk: systematic risk and unsystematic risk (or idiosyncratic risk) (Sharpe 1964). Specifically, systematic risk is also known as "market risk" or "undiversifiable risk" and is risk associated with the uncertainty inherent to the entire market or entire market segment (Jordan et al. 2011). On the other hand, unsystematic risk of idiosyncratic risk is risk caused by firm-specific events, such as company management's decisions on financial policy, investment policy and operations. Idiosyncratic risks are peculiar to a particular company and stock are can be triggered of by events such as location of operations and company culture, poor management, a worker strike, or product defects (Jordan et al. 2011).

Based on the stakeholder theory (Freeman 1984) and resource-based view theory (Barney 1991), we argue that positive CSR and negative CSR does affect relationships with the major stakeholders of firms, which are reflected in firm-specific resources and thereby results in idiosyncratic risk. Previous studies in the strategic management context examined the impact of CSR engagement on firm risk. However, these studies examined the impact of CSR on systematic risk. For example, Luo and Bhattacharya (2009), Jo & Na (2012), Casey & Grenier (2014) and Park et al.(2017) all found that CSR buffers the effect of systematic risk, Park et al. (2017) examine the main effect of positive and negative CSR activities on firms' systematic risk (i.e., beta), found the positive and significant effect of positive CSR activities on reducing risk. Similarly, Hsu and Chen (2015) also found that Positive CSR ratings were associated with reduced financial risk while negative CSR performance scores led to increased financial distress. As such it is expected that both PCSR and NCSR will influence a firm's idiosyncratic risk. In general, both positive and negative CSR affect the equity of firms with their key stakeholders and thus can influence their idiosyncratic risk. Therefore, we propose that:

H2a: Positive CSR would have a negative effect on the idiosyncratic risk of firms.

H2b: Negative CSR would have a positive effect on the idiosyncratic risk of firms

## 2.5 The Moderating Roles of Firm Size

Researchers have pointed out strategic differences between large and small firms raising the question of whether small firms stand to benefit more or less than large firms from CSR (Dixon-Fowler et al. 2013). On one hand, based on resource-based view theory, large firms may have more resources than small firms allowing for advantages associated with scale and greater investment in R&D and new technologies (McWilliams & Siegel 2010) while small firms may not have the slack resources to address CSR performance. Conversely, it is possible that small firms are not burdened by the inertia of their larger counterparts and are more flexible, making them better able to respond to social and environmental challenges and organizational change. Based on this argument, we proposed that:

H3a: The relationship between PCSR and CFP is moderated by a firm's size, such that the positive relationship between PCSR and CFP is stronger when the firm's size is higher.

H3b: The relationship between NCSR and CFP is moderated by a firm's size, such that the negative relationship between NCSR and CFP is stronger when the firm's size is lower.

H3a: The relationship between PCSR and Idiosyncratic risk is moderated by a firm's size, such that the negative relationship PCSR between idiosyncratic risk and idiosyncratic risk is stronger when the firm's size is higher.

H3c: The relationship between NCSR and Idiosyncratic risk is moderated by a firm's size, such that the positive relationship between NCSR and Idiosyncratic risk is stronger when the firm's size is lower.

## 3. CONCLUSION

Firms should be continuously innovative and constantly strive to quickly create new competitive goods and services in the course of discharging their corporate social responsibility (CSR) going by the improvements they will earn in their corporate financial performance (CFP). Understanding the process through which CSR leads to CFP will provide a better understanding of the relationship will guide the management on CSR investment and will encourage them to take part in CSR. CSR enables companies to reduce firm risk, create value, and new modes of operations that may be more efficient in resource utilization and will benefit the company in the long-term; the key practice of staying ahead of competitors. If the proposed framework is validated, the findings will provide a significant contribution to the academics, managers and practitioners.

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