Effect of Corporate Social Responsibility on Financial Performance of Licensed Commercial Banks in Sri Lanka

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ABSTRACT

Even though many companies pay attention to Corporate Social Responsibility (CSR), whether CSR activities improve financial performance remains a puzzle. Therefore, this study investigates whether corporate social responsibility affects financial performance using 17 licensed commercial banks in Sri Lanka as the sample. The data was collected for 11 years from 2010 to 2020 from the published annual reports. The CSR was measured under four main dimensions namely, environment, customer relations, human resources, and community involvement. Return on assets (ROA) and return on equity (ROE) were used to measure financial performance. Bank size and leverage were used as control variables. Results of the regression analysis indicated that CSR positively affects financial performance. This could be probably due to the fact that community-involved CSR practices such as, creating job opportunities, supporting education, supporting culture and sport, and funding scholarship programs are highly expected by society. Therefore, the reputation of banks might improve when they fulfil these societal expectations. This intern can positively affect financial performance.

Keywords: Bank size, Corporate social responsibility, Leverage, Return on assets, Return on equity

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ISBN: 978-624-5553-28-0

1. Introduction

Corporate social responsibility (CSR) can be described as an integration of economic, environmental, and social concerns to meet the expectations of interested parties. Some factors such as company size, culture, stakeholder expectations, and customer demand affect the extent to which the firms engage with CSR activities. There are four components of CSR, namely, ethical, economic, legal, and philanthropic CSR. Ethics are defined as the core values of a business. Entrepreneurs should be conscious of, what they need to do, what is right, and what is legal when they run their businesses (Pinkston & Carroll, 1996). According to Schwartz (2011), owners of firms must be honest with other stakeholders. The economic component of CSR explains that firms need to identify effective CSR activities which can provide a greater service to society (Pinkston & Carroll, 1996). According to Carroll (2016), all businesses are legally bounded to perform socially friendly practices. The philanthropic component suggests that companies need to give back to society by supporting community education, health, and human services and providing things that are better for the community, and engaging in volunteerism (Carroll, 2016).

Most modern organizations attempt to fulfil the expectations of not only shareholders but also other stakeholders such as customers, employees, suppliers, the environment, and the community (Balabanis et al., 1998). Businesses can succeed by properly meeting the expectations of all stakeholders (Lin et al., 2009). According to Davis (1975), the early mission of the businesses was limited to producing the best quality products or services at lower possible prices and distributing them effectively. Nevertheless, with the change in the commercial world, this business mission was turned towards satisfying other social needs as well. Businesses thrive on society. Further, society and firms are interdependent as firms earn profit through society. Therefore they need to provide maximum contribution to the welfare of society (Acquier et al., 2011). For this, the firms must engage in socially-friendly activities (Porter & Kramer, 2007).

Although many companies fulfil social responsibilities, their impact on financial performance is vague because prevailing knowledge is inadequate to address the aforesaid difficulty (McWilliams & Siegel, 2000; Sekhon & Kathuria, 2019; Suteja et al., 2017). Some researchers argue that CSR improves financial performance (Cho et al., 2019; Eneh & Joy, 2016) while others argue CSR contributes to decreasing financial performance (Elouidani & Zoubir, 2015). Among these, some studies do not detect any relationship between these two concepts (Aupperle et al., 1985; Ramzan et al., 2021). They argue that the impact of CSR on financial performance was weak and lacks overall consistency (Balabanis et al., 1998). According to Lech (2013), firms cannot use CSR as a determinant of financial performance. However, Greening & Turban (2000) state that CSR assists firms in improving their reputation and sustainable existence. This in turn improves financial performance. Further, the literature is mainly centered on two main theories, namely, classical theory and stakeholder theory. The viewpoints of these two theories differ. The classical theory claims that CSR causes competitive disadvantages due to unproductive costs (Chtourou & Triki, 2017). Therefore, businesses need to run in the best interest of owners (Friedman, 2007). The stakeholder theory explains the link between stakeholders' management and the achievement of firms' objectives such as profitability and growth (Freeman & McVea, 2001). Firms engaging in better stakeholder management practices can account for higher firm performance (Donaldson & Preston, 1995).

When considering the Sri Lankan context, many studies conducted on CSR. However, these are also not sufficient to find a clear relationship between CSR and financial performance.

Some researchers said that CSR affects to improve financial performance (Balagobei & Anandasayanan, 2018; Wijesinghe & Senaratne, 2011). However, Basnayake (2015) argued CSR causes to decline in financial performance. Gunawansha & Swarnapali (2021) stated that different types of CSR practices differently affect financial performance. Then, it is difficult to identify how CSR affect financial performance. Hence, this study is conducted to assess how CSR affects the financial performance of the banking sector in Sri Lanka.

2. Literature review

Several theories describe how CSR affects financial performance (Jitaree, 2015). According to the stakeholder theory, managers need to consider whether both shareholders' and other stakeholders' expectations are met. The success of a firm depends on the extent to which it meets the requirements of all stakeholders (Jitaree, 2015; Lech, 2013; Theodoulidis et al., 2017). For that, businesses are able to create a safe working environment, move to green products, follow socially responsible production processes and provide public health services (Chtourou & Triki, 2017). Kabir & Thai (2017) state that firms can directly achieve their targets through CSR activities because CSR creates a positive perception of the business in the customers' minds. This ultimately leads to improve financial performance (Ramzan et al., 2021). According to Ruf et al., (2001) as well, CSR affects long-term profitability. Further, institutional theory and resource-based theory explain how CSR practices contribute to enhance financial performance (Brammer & Millington, 2008). The institutional theory suggests that firms need to institutionalize good organizational behavior to engage in socially friendly practices because a firm can earn more profits by breaking the gap between the firm and society (Brammer et al., 2012). The resource-based theory emphasizes that CSR practices internally assist in obtaining employee loyalty and expertise and externally lead to a better firm image and customer loyalty (Hillman & Keim, 2001). Nair & Bhattacharyya (2019) have assessed how CSR affects financial performance in Indian firms based on the institutional theory and resource-based theory. Under the institutional theory, they focused on CSR intensity, staff welfare, and training intensity. Research and development intensity and advertising intensity have been used under resource-based theory. According to the results, CSR enhances financial performance. Hence, the institutional theory and the resource-based theory support the stakeholder theory (Hamidu et al., 2015).

The classical view and agency theory explain that CSR reduces financial performance (Seifert et al., 2003; Vance, 1975). Under the classical approach, firms need to engage in social projects only if such projects enhance the stockholders' wealth (Chtourou & Triki, 2017). Social or government CSR practices do not improve financial performance (Jha & Rangarajan, 2020) because, costs increase if managers engage in socially responsible practices (Hirigoyen & Poulain, 2015). Further, Doshi et al., (2018) state that, CSR takes a long period to get profitable benefits. But, firms can quickly get benefits through advertising. Since the funds spend on CSR reduce the amount for advertising, firms tend to spend more on advertising than on CSR. Some firms misallocate scarce resources for ineffective CSR operations because they do not have a definite idea about effective CSR practices. This results in reduced financial performance (Hasan et al., 2018). The agency theory is an extension of the classical approach. It indicates that managers are agents who act on behalf of shareholders. Therefore, agency theory argues that there is no need to do more than increasing the wealth of shareholders (Doshi et al., 2018). However, some scholars argued that CSR supports avoiding agency conflict by reducing the information asymmetric between the agent and the principal (Chtourou & Triki, 2017).

Some scholars did not find any association between CSR and financial performance (McWilliams & Siegel, 2000; Sekhon & Kathuria, 2019). Moreover, McWilliams and Siegel (2000) have established a cost-benefit framework to determine the optimum level of CSR which maximize the firms' performance. However, they did not detect any relationship between CSR and financial performance. Alexander and Buchholz (1978) state that CSR does not affect stock returns. Aras et al., (2010) also did not find any significant relationship between CSR and financial performance. However, Berrone et al., (2010) state that financial performance affects CSR under the socio emotional wealth (SEW) theory. Hence, the firms with high profitability, tend to invest more money in CSR activities. When the firms' profitability is low, they ignore the investments in CSR practices. Further, there are some studies which found mixed results (Han et al., 2016). Amini & Dal Bianco (2017) state that the impact of CSR on financial performance varies with the country because, their results show a positive relationship between CSR and firm performance in middle-income countries such as Mexico and Argentina and poor countries, such as Bolivia and Colombia. However, they did not find any significant relationship between CSR and financial performance in developed countries such as Chile. Furthermore, Chetty et al., (2015) state that CSR improves financial performance in financial sectors but CSR decreases financial performance in industrial sectors.

Lioui & Sharma (2012) have found a direct and indirect effect of environmental CSR practices on ROA and Tobin's Q. They state that environmental CSR directly reduces both ROA and Tobin's Q. Further, rational managers engage in environmental CSR activities over time because it improves corporate financial performance in the long run. However, Angelia and Suryaningsih (2015) state that the environmental performance of Indonesian firms directly improves ROA and ROE. De Bussy & Suprawan (2012) state that employee-related CSR activities lead to better financial performance than customer, community, supplier, and shareholder-related CSR practices. According to Chen & Wang (2011), the firms with better financial performance, have engaged in socially friendly practices such as employee and customer relations, environmental protection, and community relation. Among these, the firms which highly engage in employee (Nawaiseh, 2015) and customer-related CSR activities (Saeidi et al., 2015) show higher financial performance than others.

Prior CSR studies conducted based on the Sri Lankan context also have mixed results. Basnayake (2015) found a negative relationship between CSR disclosures and the financial performance of domestic commercial banks in Sri Lanka. He stated that financial performance is not dependent on CSR practices, it depends on economic conditions and other macro factors. However, Jayasundara et al., (2020) stated that CSR affects to increase the financial performance of listed manufacturing companies in Sri Lanka because, when companies engage their CSR practices as satisfying the expectation of all stakeholders such as employees, community, customers, suppliers, and other interested parties, it directly leads to better financial performance. Although Gamhewage et al., (2018), found a positive relationship between environmental CSR and financial performance, Gunawansha and Swarnapali (2021) stated that customer and employee-related CSR practices cause to enhance financial performance than environmental CSR. According to Hettiarachchi and Gunawardana (2012), CSR is not individually significant with ROA and Tobin's Q. However, they are positively and jointly significant to financial performance measured in terms of ROA and Tobin's Q.

This literature review indicates the presence of various arguments regarding the effect of CSR on financial performance. The stakeholder theory suggests CSR affects to improve financial performance (Donaldson & Preston, 1995). Although institutional theory and resource-based theory (Fauzi & Idris, 2010) prove the stakeholder theory, classical view and agency theory indicate that CSR negatively affects financial performance (Herremans et al., 1993). While some researchers did not find any significant relationship between CSR and financial performance (McWilliams & Siegel, 2000) some studies found mixed results (Chetty et al., 2015). As a developing country, Sri Lanka follows CSR practices. However, its impact on financial performance is still questionable due to conflicting results (Basnayake, 2015; Jayasundara et al., 2020). Hence, it is important to conduct a study to assess the relationship between CSR and financial performance.

3. Methodology

This study investigates the relationship between CSR and the financial performance of licensed commercial banks in Sri Lanka using data for 11 years from 2010 to 2020. Out of 24 licensed commercial banks, 17 were selected as the sample using the simple random sampling technique. The data was collected from published annual reports.

CSR was measured using CSR indices representing four CSR categories namely environmental, customer relations, human resources, and community involvement following the approach of Jitaree (2015), Ho et al., (2019), & Cornett et al., (2014). Environmental CSR was measured by environmental policy, recycling activities, energy, water, and reduction of carbon emission. Customer relation CSR was measured by client issues, improving quality of life, and introducing new products. Human resources CSR was measured by employee health, remuneration, recruitment policies, employee training, and community involvement CSR was measured by creating job opportunities, supporting education, supporting culture and sport, and funding scholarship programs Ho et al., (2019). The level of commitment in these four CSR categories was measured by an index (Chtourou & Triki, 2017). A value of 1 was assigned if a bank has disclosed CSR practices relating to each aspect. Otherwise, 0 was assigned. The aggregate score in each category was taken as the CSR index Ho et al., (2019). The maximum scores for environmental, customer relation, human resource and community involved CSR index are 5, 3, 4 and 4 respectively.

Table 1: Measurements of Corporate Social Responsibility

Category	Characteristics
Environmental CSR	Environmental Policy, Recycling Activities, Energy, Water, and Reduction of Carbon Emission
Customer Relation CSR	Client Issues, Improving Quality of Life and Introducing New Products
Human Resources CSR	Employee Health, Remuneration, Recruitment Policies, Employee Training
Community involvement CSR	Creating job opportunities, supporting education, supporting culture and sport, and funding scholarship programs

Source: Prior studies. (Chtourou & Triki, 2017; Ho et al., 2019)

Financial performance was measured using ROA and ROE (Kabir & Thai, 2017). Two control variables were used in this study namely bank size and leverage (Kabir & Thai). Bank size was measured using total assets. Leverage was measured using the debt-to-equity ratio. OLS Regression model specified in equation 1 was used to analyze the data.

$$FP = \alpha + \beta_1 CI + \beta_2 EP + \beta_3 HR + \beta_4 CR + \beta_5 BS + \beta_6 LEV + \varepsilon \quad (1)$$

The regression equation hypothesizes that the Financial Performance (FP) of banks depends on the CSR practices including community involvement (CI), environmental protection (EP), human resource (HR), and customer relation (CR). Bank size (BS) and leverage (LEV) were also used as control variables that can be affected financial performance. ε Represents the random error. In regression coefficient model 1, ROE was used as the dependent variable whereas, in regression coefficient model 2, ROA was used as the dependent variable.

4. Results and discussion

As illustrated in table 2, the minimum and the maximum percentages of ROE are -6.26 and 39.36 respectively. A high rate of ROE indicates that banks have efficiently used shareholders' equity to generate income. Overall, the banks have deployed shareholders' capital properly (μ=13.27). ROA indicates some banks duly utilize their assets to obtain profitable returns. Moreover, the ROE of banks has significantly changed during the period (SD=8.02) but the ROA of banks is clustered around the mean (μ =1.17, *SD*= 1.09). It indicates that there is no significant change in ROA during the period.

Table 2: Descriptive Statistics

Variable	Min	Max	Mean	SD
ROE (%)	-6.26	39.36	13.27	8.01
ROA (%)	-1.35	11.91	1.17	1.09
Environment CSR Index	.00	5.00	3.27	1.88
Customer CSR Index	.00	3.00	2.42	1.02
Employee CSR Index	.00	4.00	2.49	1.21
Community Involvement Index	.00	4.00	2.31	1.29
Bank Size (Total Assets)	8.18	12.47	11.48	.71
Leverage	1.00	29.00	10.91	5.00

Source: Research Findings 2010-2020

The environmental CSR index (μ =3.27, *SD*=1.88), Customer CSR index (μ =2.42, *SD*=1.02), employee CSR index (μ =2.49, *SD*= 1.21) and community involvement CSR index (μ =2.31, *SD*= 1.29) indicate that banks are engaged CSR practices to some extent. The log of total assets of the banks is clustered around the mean (μ=11.48, *SD*=0.71). It indicates that the size of selected banks is not much changed during the period. When considering the minimum (1) and maximum (29) value of leverage, it also shows a higher range. Further, the leverage of banks has significantly changed during the period (*M*= 10.9, SD=5.0)

The Durbin Watson test shows the presence of a weak positive autocorrelation in the model for both financial performance measurements namely ROE (*DW= 1.58)* and ROA (*DW= 1.52)*. The overall regression model for both ROE [F (6, 21), p<.001] and ROA [F (6, 2.7), p = .015)] is statistically significant. Furthermore, around 43.2 percent variation in ROE (R^2 = .432) and 9.4 percent variation in ROA (R^2 = .094) are explained by the explanatory variables. As shown in Table 3, out of four CSR categories, only community-involved CSR has a statistically significant positive association with ROE. None of the other CSR indices (environment, customer, and employee) shows a statistically significant relationship with ROE. Further, bank size is not statistically significant but leverage has a significant positive effect on ROE. As illustrated in Table 4, community-involved CSR and customer relation CSR have a statistically significant association with ROA. The results suggest that community-involved CSR improves ROA and customer relation CSR reduces ROA. None of the other CSR indices (environment and employee) show any significant relationship with ROA. Further, bank size and leverage do not show any significant relationship with ROA.

Literature on the relationship between CSR and financial performance is mixed. Similarly, the overall result of this study is also mixed. In summary, only community involvement CSR practices affect to increase both ROE and ROA. However, there was no sufficient evidence to claim an impact of environmental, employee, and customer-related CSR on financial performance. These results are consistent with some previous studies. For example, Nyeadi et al. (2018) explain that there is less evidence to claim the relationship between environmental CSR and the financial performance of listed firms in South Africa. According to Maqbool and Hurrah (2020), environmental CSR and governance CSR are not affected to the improvement or decline in financial performance but community-involved CSR practices affect the improvement of financial performance in Indian firms. Weber (2017) also has the same idea regarding environmental CSR and financial performance. Cherian et al. (2019) found that employee-related CSR practices affect the improvement of financial performance other than the environment, education, and community-related CSR practices. However, customer-related CSR affects the decline of financial performance of Indian firms. Chtourou and Triki (2017) have conducted their research by using philanthropic, innovative, and altruistic actions as measurements of CSR. Any hypothesis related to the relationship between CSR and financial performance was not proved but altruistic actions showed a significant impact on financial performance in the Tunisian context.

Table 3: Regression Coefficients – Model 1

Dependent Variable*: ROE* [R^2= .432, **DW** = 1.582, **p**< = .001]

Variable	**β**	**t**	***VIF***
Constant	-6.415	-.795	
Environment CSR Index	-.125	-.391	1.403
Customer CSR Index	-.859	-1.192	1.098
Employee CSR Index	-.145	-.276	1.160
Community Involvement Index	1.169*	2.570	1.349
Bank Size	.825	1.203	1.146
Leverage	.883*	8.614	1.212

Note: * indicates statistical significance at 5 percent level

Table 4: Regression Coefficients – Model 2

Dependent Variable: ROA [R^2= .094, ***DW*** = *1.522,* ***p*** = *.015*]

Variable	**β**	***t***	**VIF**
(Constant)	.347	.530	
Environmental CSR Index	.004	.170	1.404
Customer CSR Index	-.130*	-2.228	1.099
Employee CSR Index	-.015	-.346	1.161
Community Involvement Index	.104*	2.807	1.340
Bank Size	.069	1.237	1.161
Leverage	-.002	-.236	1.214

Note: * indicates statistical significance at 5 percent level

5. Conclusion and implications

Although many inconclusive arguments are presented among prior studies, the results of this study indicate that CSR has a statistically significant positive impact on financial performance. It can be argued that society expects community-involved CSR practices such as creating job opportunities, supporting education, supporting culture and sport, and funding scholarship programs. This type of CSR activities affect financial performance more strongly than environmental, customer relation and human resource CSR. When a bank is involved with these activities, the reputation of the banks increase. This creates a new customer base and motivates investors. Hence, this in turn positively affects financial performance. When the banks meet the requirements of the community, it causes better financial performance. Therefore, the results of this study support the stakeholders' theory which revealed that CSR has both long-term and short-term financial implications. However, there is no evidence to state a relationship between environmental, customer, and employee-related CSR with financial performance. Hence, it is difficult to state how environmental, employee and customer-related CSR affect financial performance. Finally, the results suggest that further studies are needed to investigate the relationship between different types of CSR and financial performance. The results of this study can be useful for future researchers to explore the impact of environmental, customer relations, and human resource CSR practices on financial performance in the banking sector.

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