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On the Relationship between Social Responsibility and Financial Performance – The Need for Theoretical Convergence

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Abstract. This paper discusses the main theoretical arguments that support a possible relationship between corporate social responsibility (CSR) and corporate financial performance. The last years have seen an increase in the number of academic contributions that examine the link between CSR and financial performance from a theoretical, empirical or managerial perspective. The debate accompanying these academic contributions is vivid, without leading to the formulation of a unified opinion on whether a causal relationship between social and financial performance exists and its nature – unilateral or bilateral. By analyzing the main contributions of existing literature in the field, we aim at providing a synthetic view on the approaches on the matter and advance a new perspective that focuses on the convergence between social and financial performance.

Keywords: Corporate Social Responsibility, Corporate Social Performance, Financial Performance

1. Introduction

In an increasingly competitive global market, companies, whether multinational or domestic, adopted progressively more refined and sophisticated business solutions, aimed at identifying the optimum balance between the long-term versus the short-term horizon in terms of profit, or integrated approaches. In illustrating the same idea, different publications provide annually various rankings – of perception on corporate reputation, on the degree to which companies are admired, or on the extent they deserve to work for them, etc. In this framework, the pressure that shareholders and various interest groups exert on companies in terms of assuming various responsibilities from a social, moral, legal and financial perspective, has led in recent years to significant changes in the manner companies carry out their obligations. Thus, as emphasized by Barnett and Salomon (2006), a growing number of investors become interested not only in companies' financial performances, but also in how companies meet their social responsibilities, leading inevitably to changes in the pure financial orientation to take into account other aspects of firm performance.

Our paper discusses the main theoretical arguments that support a possible relationship between CSR activities and corporate financial performance, given the increased number of academic contributions that examine the link between the two, from a theoretical, empirical or managerial perspective. The paper is structured as follows: Part 2 reviews the main highlights of the relationship between CSR and financial performance, Part 3 presents and organizes the most important academic contributions on the link between social and financial performance, and Part 4 discusses and concludes.

2. The Evolving Relationship between CSR and Financial Performance

One may observe a strong link between the way the concept of CSR evolved and the modalities of acknowledging firm's performance. Crifo and Ponssard (2008) analyze three typologies of firm governance that developed across the years, as follows: from the '50s to the '80s we see the presence of national models of social responsibility, then the value creation model is developed in the '80-2000, while the period after 2000 is dominated by the model of the "citizen company". While national models of social responsibility have focused on governments' intervention, needed for the recovery of Western economies after the Second World War, the period being marked by directing the value created in the businesses exclusively towards the

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company itself - by investing in additional production capacity and business diversification - and the employees, the social responsibility model that focuses on value creation that emerged after the '70s oil shocks and the global economic downturn has noticeably changed the way the relationship between companies and financial markets is understood.

As economies became more deregulated, under augmented competition and globalization of economic phenomena, institutional investors have created departments for the management of corporate equity portfolios and began to exert more influence over companies' performance and governance. Since the 2000s, however, as the above-mentioned authors appreciate, the value creation model began to be questioned, as long-run investments started to make increasingly more room for those with a short-time horizon. One of the consequences of reconsidering the investment time horizon is observable through the values of PER (price-earnings ratio), which shows the ratio of current equity price and the earnings per share. Theoretically, the higher the value of this indicator, the higher the expectations of investors concerning the company should be. When one observes PER values in the United States, they increased since the late' 80s from 11.59 in 1988 to 46.51 in 2001, followed by a decrease in values, following the so-called "dot.com bubble" crisis. We also note a steeper increase of PER after 2008, only that this time the main cause of the increase were the small profits per share paid by U.S. companies, in the context of weak performance due to the global financial crisis. Similar evolutions for PER values are also observable for other stock markets.

Financial markets' confidence in corporate management decreased dramatically after the crisis of the early 2000s, based on the finding that value creation outcomes were unfairly divided between shareholders and managers, in favor of the latter. At the same time, efforts directed towards sustainable development have increased, although the Brundtland Report (also known as Our Common Future Report) had been published in 1987. Capron and Quairel-Lanoizelée (2010) point out that the World Summit for Sustainable Development held in Johannesburg in 2002 created the framework for building a "business ethics" focused on the societal intervention of the company-citizen aimed at balancing national and international policy options. Thus, if by that time financial theory cherished as reference the efficient markets hypothesis and self-regulation principles, afterwards the shareholder view of the firm gave way to the stakeholder perspective, which considers the shareholders as one stakeholder group, alongside with consumers, employees and citizens. Consequently, institutional investors have begun to offer investors the opportunity to invest in socially responsible investment (SRI) funds in order to capture in this manner the interest of new shareholders for social responsibility initiatives undertaken by companies.

A milestone in the evolution of "corporate-citizen" status of the company is marked by the publication of Sarbanes-Oxley Act in the United States in 2002, a federal law that establishes or strengthens a number of standards applicable to U.S. companies' boards, as well as to accounting and management consultancy companies. The Act makes reference to the requirement addressed to top executives to certify the accuracy of financial information published by individual companies, gives higher independence to external auditors and increases the level of supervision of companies' boards on managerial activities, while setting higher penalties for the conduct of fraudulent activities. The law, which followed a number of corporate scandals in the early 2000s, of which the best known are the Enron and WorldCom bankruptcies, had correspondence in other countries. An example is the NRE law in France (fr. la Loi sur les Nouvelles Regulations Economiques), published in May 2001, which requires French companies to submit in their annual management reports information on the consequences of their activities on the environment and society, in addition to the usual accounting and financial information. Financial markets have reacted by incorporating in the companies' evaluation process extra-financial factors, the best examples being the creation of specialized rating agencies on corporate social responsibility (such as Asset 4, EIRIS, KLD or Vigeo) and the construction of stock market indexes that take into account different types of social responsibility initiatives (e.g. Dow Jones Sustainable Index, FTSE 4Good, Calvert Social Index, FTSE Johannesburg Stock Exchange Socially Responsible Index, Sao Paolo Stock Exchange Corporate Sustainability Index , Morgan Stanley Capital ESG indices etc.).

3. Social Corporate Performance and Financial Performance – a review of Theoretical Arguments

Clarifying the impact of CSR on economic and/or financial corporate performance was the subject of numerous studies, which focus on the nature of the interaction between firms' ability to achieve a high level of corporate social responsibility, on the one hand, and financial performance, on the other. In principle, one can identify in the existing literature three levels of analysis of the interaction between corporate social performance and financial performance (Gond and Igalens, 2012, p 79): the first level is the theoretical one, which focuses on the mechanisms that might be able to explain the relationship between the two variables; the second level is the empirical one, seeking practical understanding of the relationship between corporate social performance and financial performance by the use of various indicators that measure social or financial performance, respectively, and by employing diverse statistical and/or econometric tools; and the third level, the managerial one, which aims at building a "business case" for CSR.

Although, in principle, developments in the literature on the relationship between companies' social and financial performance derive their strength from the views promoted by Friedman (1970) and Freeman (1994), many of the subsequent developments on the matter are debatable and can be easily subject to doubt. Given that the literature offers many definitions of corporate social responsibility, the transformation of social responsibility in a variable that can be measured one way or another is essential for modeling the relationship between social responsibility and financial performance. Thus, the literature developed gradually the concept of "corporate social performance" in order to provide consistency to the practice of corporate CSR. Among the first authors who advanced this new concept were Waddock and Graves (1997) and Graves and Waddock (1999), noting that the approaches proposed in the literature are tools that provide measures of firms' organizational behavior by taking into account criteria such as size, process and outputs for different business activities in terms of sustainable investments, investments for pollution control, treatment of women and minorities, relations with employees and the general policy of human resources, community relations and social programs such as philanthropy. Wood (1991) also proposed the understanding of corporate social performance as one integrated company business, but distanced from its current operations, in order to have a better view on the relationship between business and society.

Regarding the theoretical foundations of the relationship between social and financial performance, explanations found in the literature are structured around three categories, as follows: (1) explanations that suggest the existence of a linear relationship between social and financial performance, (2) explanations that suggest the existence of a complex and non-linear relationships between social and financial performance, and (3) explanations that argue for the absence of a stable link between social and financial performance. Figure 1 summarizes these theoretical explanations, which we will further develop.

Type of expected causality	**Nature of relationship between social and financial performance**	
	Linear relationship	
	Positive relationship	**Negative relationship**
Unilateral causality: social performance causes financial peformance	Social positive impact or performing management	Compromise
Unilateral causality: financial performance causes social performance	Slack resources or organizational games	Opportunism
Bilateral causality: social performance causes financial performance and financial performance causes social performance	Positive synergy	Negative synergy
No causal relationship	**Lack of a relationship between social and financial performance**	
	More complex relationship / non-linear relatioship	

Source: Table adapted by authors, based on Gond and Igalens (2012) and Preston and O'Bannon (1997)

Fig. 1: The type and nature of causal relationships between social and financial performance

The unilateral causality, from social to financial performance, can be explained theoretically by the efficient corporate management or the positive social impact of CSR initiatives: companies with high levels of social involvement demonstrate abilities to manage the costs that these activities involve, on the one hand, and the negative externalities, on the other hand, signaling the quality of their management to interested stakeholders. On this line of theoretical analysis, investors infer a high corporate social performance as a sign of efficient management and reward companies who behave socially responsible. Assuming a unilateral causality from social to financial performance, but of a negative type, one may assume the existence of a compromise between the two areas of performance, as firms may opt for investments in one of the two, but

not in both simultaneously. The other direction of causality, from financial to social performance, suggests that firms that are financially strong often have good social performances because of the available funds they dispose of and that can be directed to social initiatives. This explanation is known in the literature as the "slack resources" theory, promoted by authors such as Jensen (1986). The negative relationship is based on the understanding provided by Williamson (1992) on the opportunistic behavior of managers, which involves manipulating the company's stakeholders, including shareholders, in order to make strategic investments in the social performance of the firm, when the firm's financial performance is low. Thus, we are dealing with a framework which means that when the company's financial performance is low the social performance is high, and vice versa, the focal point being the opportunistic behavior of management.

The bilateral positive causal relationship between social and financial performance is proposed by Waddock and Graves (1997) and refers to a situation where a virtuous circle between the investment in social performance that generates superior financial performance and then allows firms to obtain resources required for investments in more social responsibility initiatives exists. In contrast, the negative bilateral causality characterizes a possible vicious cycle of CSR, where the efforts to increase the firm's social performance reduce financial performance, which in turn adversely affects social performance.

The absence of a link, especially a stable link between social and financial performance can be explained either by the inability to identify a relationship between the two variables, given the complex and indirect interaction between them, either by the equilibrium model proposed by McWilliams and Siegel (2001), the latter assuming the existence of a supply of CSR from corporations and of a demand for CSR from consumers. In this context, as firms offer a higher "amount" of social responsibility, which naturally increases their costs, they can benefit from a higher demand for their goods, which include "more" social responsibility. On the other hand, consumers may also incur additional costs, given that they purchase costlier goods produced by socially responsible firms, but up to a point; at equilibrium, when the associated profit opportunities associated to the supply of social responsibility are exhausted and the firm's positioning in relation to social responsibility no longer affects its profitability, the relationship between social and financial performance becomes neutral. The last type of relationship between social and financial performance, complex and possibly non-linear, is introduced by Barnett and Salomon (2006), with reference to socially responsible investments. The two authors show that an increase in the social criteria considered when making allocation decisions by investment funds' managers will, initially, lead to a decrease in the performance of investment funds due to higher costs associated with a more difficult diversification. Later, however, as multiple criteria are met, the fund's performance increases, given that investments are targeted to better managed and more profitable companies.

4. Discussion and Conclusions

The debate accompanying the theoretical academic contributions on the relationship between corporate social performance and financial performance is rather vivid, without leading so far to the formulation of a unified opinion on whether a causal relationship between social and financial performance exists and its unilateral or bilateral nature. Moreover, the abundant empirical contributions in the field – see, for example, the excellent "meta-studies" on the literature provided by Orlitzky et al. (2003), Allouche and Laroche (2005), or Gond and Igalens (2012) – have not been able to offer any conclusion on the matter, although it seems that the relationship between social and financial performance is more likely to be positive.

Recently, a significant contribution, in our view, to the theoretical understanding of the relationship between social and financial performance is advanced by Gond (2010), which proposes a model of convergence between social and financial performance, through two complementary mechanisms that allow updating investors' perceptions and behaviors on the relationship between social and financial performance of firms: on the one hand, there is a "priming" mechanism (fr. "amorçage"), which refers to performance-generating processes that structure actors' beliefs and the ways and means by which they disseminate these beliefs and make them known; on the other hand, there is a "locking" mechanism (fr. "bouclage"), which takes into account the tools through which the belief-related behaviors can contribute to the validation of convergence between firm's social and financial performance. Thus, the priming mechanism is structured around the level of language and concepts used by economic actors to convey the CSR message, of adopted

social norms and of institutional arrangements promoted by them. These three dimensions allow the inclusion of different processes through which firms operating in the field of CSR can trigger or, conversely, prime the construction of the process leading to convergence between social and financial performance towards stakeholders in financial markets. This mechanism can be considered as a leveraging action that financial market participants, and especially those that invest in socially responsible companies - either through individual investments or through socially responsible investment funds –, have at their disposal to facilitate the cognitive framing of the concept of convergence between social and financial performance. The locking mechanisms on the other hand, describe the stages through which beliefs and perceptions of economic actors can change from the design stage to reality in financial markets.

Therefore, we could say that it is possible to build a progressive and orderly relation between social and financial performance, the locking mechanisms accounting in this context as the instrument through which financial markets can determine companies to engage in socially responsible activities. In this framework, the relationship between corporate and financial performance becomes bi-univocal and takes correctly into account the issue of perception regarding the company's CSR activities and its managerial implications, which is an aspect rather ignored in the existing literature.

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