CHAPTER 2
THEORETICAL FRAMEWORK

2.1 Definition of Corporate Social Responsibility

Business for Social Responsibility states that CSR is: “achieving commercial success in ways that honour ethical values and respect people, communities and the natural environment.” Furthermore, they explain that CSR is a comprehensive set of policies, practices and programs that are assimilated into business operations, supply chains, and decision-making processes throughout the company pertaining to issues such as business ethics, community investment, environmental concerns, governance, human rights, the marketplace and the workplace (Tsoutsoura, 2004).

In accordance with a strategic advisory group on CSR, the International Organization for Standardization defines CSR as (Leonard & McAdam, 2003):

*Corporate social responsibility is a balanced approach for organizations to address economic, social and environmental issues in a way that aims to benefit people, communities and society.*

The European Commission (2008) describes CSR as:

*A concept whereby companies integrate social and environmental concerns in their business operations and in their interactions with their stakeholders on a voluntary basis.*

Consistent with the view, Belu and Manescu (2009) argue that CSR is a corporation’s responsibility to integrate environmental, social and governance practices into their
business model beyond mandatory legal requirements. McWilliams and Siegel’s research also follows the belief that CSR is pursuing social good beyond the requirement of law (Tsoutsoura, 2004).

Gray et al. suggest that CSR involves extending the accountability of organizations beyond the traditional role of providing financial account to shareholders, which will entail communicating social and environmental effects of organization’s economic actions to particular interest groups within the society (Oeyono et al., 2011). Moreover, Frooman’s work also contends that CSR is an action by the firm that can substantially affect an identifiable social stakeholder’s welfare (Tsoutsoura, 2004).

Frederick believes that business corporations have a moral imperative to work for the social betterment (Jackson & Apostolakou, 2010). Huang (2010) supports the view by defining CSR as the obligation of firms to be responsible for the environment and stakeholders beyond the financial duties.

Carol posits that social responsibility of business comprises the economic, legal, ethical and a discretionary expectation the society has of an organization at a given point in time (Jackson & Apostolakou, 2010). Wood suggests that CSR is a reflection of the idea that business and society are interwoven rather than separate entities; consequently, society has certain expectations for acceptable business behaviour and outcomes (Jackson & Apostolakou, 2010). Bakker et al.’s views are similar, arguing that CSR is a reflection of societal expectations of corporate behaviour that is expected by the society and stakeholders, or is morally required, ergo is justifiably demanded from a business (Jackson & Apostolakou, 2010).
2.2 Rationality Behind Conducting Corporate Social Responsibility

The voluntary nature of CSR has resulted in the flexibility of implementation and reporting on socially responsible activities. The diverse level of engagement and reporting in CSR is due to factors such as differences in company’s size, industry, corporate culture, stakeholder demands and past historical involvement in CSR (Tsoutsoura, 2004). Adams (2004) suggests the reason for non-disclosure is because of a reluctance to report on the negative impact and the social and political context the time disclosures are made. Corporations recognize the importance of continually improving the performances and show greater accountability, which enables transparency of CSR practices and behaviour (Golja & Nižić, 2010). Tsoutsoura (2004) explains that it is imperative CSR strategy is aligned with the corporate objectives and core competencies, and management as well as employees are committed to the CSR principles.

The following theories in this subchapter explain why companies choose to engage in CSR activities. Stakeholder Theory and Legitimacy Theory is included to show how both of the theories in practice are interrelated and overlapping, while Institutional Theory is also included as it is an extension of both the Stakeholder and Legitimacy theory (Deegan, 2009).

2.2.1 Stakeholder Theory

According to Deegan (2009), there are two branches of Stakeholder Theory, the Ethical Branch and Managerial Branch, which will be considered separately in this section.

*Ethical branch* of Stakeholder Theory states that all stakeholders have an intrinsic right to be treated fairly by an organization, since the affect of the organization on the life of a
stakeholder should be what determines the organization’s responsibilities, instead of the stakeholder’s economic power on the organization (Deegan, 2009). Freeman and Reed (1983) define key stakeholders as any identifiable group or individual who can impact the achievement of an organization’s goals, or is affected by the achievement of an organization’s goal. Clarkson (1995) divides stakeholders as primary and secondary stakeholders. Primary stakeholders are those without their continuous participation, a corporation cannot survive as a going concern; while secondary stakeholders are those who can influence or are influenced by the corporation but do not engage in transactions and are not important for its survival. The ethical perspective relies on the notion that all stakeholders have certain minimum rights that must not be violated, and the right is extended to include the right to know how the organization affects them (Deegan, 2009), which is why CSR reports are produced.

The moral obligation argument arises from a greater corporate accountability due to a growth in the size, power, global spread of multinational companies as well as increased awareness of environment and social impacts of companies (Adams, 2004). Tsoutsoura’s (2004) research also states that shift of power has occurred which results in an expanding role of companies and responsibility to address social problem. Current trend also supports the view of public clamour on a clearly defined sustainability report due to rapid growth of sustainability reporting investing since the 1990s, and society’s demand for involvement of community by corporations (Tanimoto, 2004). The poverty of a nation, political unrest and exploitation of natural resources can have devastating impact on a business (Tsoutsoura, 2004), which explains why companies should have an active role in contributing a positive difference to society. Business organizations have
societal obligations surpassing economic functions of producing and distributing scarce 
goods to generate a satisfactory level for consumers or profit for shareholders (Hill et al., 
2007), that is to be socially and environmentally responsible.

Corporations should focus on all stakeholders concerns since it is a part of a managerial 
duty and a fiduciary responsibility (Hine & Preuss, 2009). Managers that have moral 
awareness and focus on increasing productivity within a system where all stakeholders 
voices are heard will typically use fewer resources, employees will be more committed 
and the market will be satisfied (Heizer & Render, 2011). Research suggests that 
consumers will punish firms that are perceived as insincere in their social involvements, 
showing a negative impact on consumer attitude if firms engage CSR merely for 
strategic motive (Ven, 2008). By addressing a specific social or environmental issue, a 
firm acknowledges the importance of the matter, consequently, stakeholders are more 
likely to identify with the organization and identify to the value of the organization that 
shows ethical concern (Peloza & Papania, 2008).

The Managerial Branch of Stakeholder Theory states that corporate management have a 
higher tendency to attend to the expectations of powerful stakeholders (Deegan, 2009). 
Deegan (2009) suggests that the more important the stakeholder to the organization, the 
more effort will be applied to gain approval of the stakeholders. A framework to identify 
stakeholders in accordance to the relative importance of each type of stakeholders is as 
follows (Mitchell et al., 1997):

1. Power, the extent a stakeholder can pressure its influence on the organization.
2. Legitimacy, the demands of the society to conform to the norms, values and beliefs of the general community.

3. Urgency, the extent the stakeholder need immediate attention from firm.

Primary stakeholders have legitimate demands, and managers have both urgency and power, whilst secondary stakeholders have legitimate claims, but lack urgency and power to enforce the claims (Mitchell et al., 1997). Stakeholders that lack power, urgency or legitimacy rely on other groups that possess the traits to defend the values they embrace (Peloza & Papania, 2008). Priorities change among stakeholder groups and circumstances produce new issues of importance, which creates new classes of stakeholders to be considered by the company (Peloza & Papania, 2008).

Voluntary disclosure theory supports the managerial branch of stakeholder theory where companies that engage in CSR want to differentiate themselves as a strategic effort, thus, will inform their key stakeholders regarding their performance (Sutanto, 2008). Strategic management according to Dessler and Huat (2009) is defined as the process of identifying and executing the company’s mission by corresponding its capacity with the demand of its environment. Thus, strategic CSR involves aligning company’s mission with the desired CSR in accordance with the stakeholders’ demand in the company’s environment. Boesso and Michelon’s (2010) findings proved that companies have direct initiatives and reporting to key stakeholders that are perceived to be more influential on firm’s activities, consequently, having an incentive to engage in strategic CSR. Belu and Manescu (2009) support the argument by stating that CSR involves a wide range of issues to be addressed, resulting in a different approach for all companies will be necessary because some issues are more relevant than others. Dooley and Lerner (1994)
believe that strategic decisions are influenced by managerial values and characteristics, and limitation of the strategic decision-making can arise due to internal and external constraints of the organization.

A benefit of strategic form of CSR includes serving the interest of owners should provide social satisfaction for citizens, appeal to social entrepreneurs and managers hired can maximize profit and market value of the firm (Baron, 2005). Another benefit of strategic management of CSR is the ability to enhance competitive advantage by reducing the costs or better serving a certain stakeholder’s needs through managing stakeholder relationships (Boesso & Michelon, 2010) (Hine & Preuss, 2009). Porter and Kramer argue in line with strategic CSR that success is a result of correct choices on which social issues to focus on, corporation can not choose a particular social issue merely for moral values but should utilize company’s resource to enhance firm’s competitiveness (Boesso & Michelon, 2010). Husted and Salazar support the view by arguing overall social output of CSR can be greater if companies aim for strategic goals instead of altruistic motives (Hine & Preuss, 2009) through considering employment, profitability, shareholder value and capital market responses in relation to CSR. Further, Heal (2004) believes CSR can contribute to a firm’s long-term profitability arguing that it takes time for CSR to affect a firm’s reputation and performance, which proves that CSR can be used as a strategic management tool. Consistent with Friedman’s and managerial aspect of stakeholder theory, companies will only conduct CSR if it generates higher profit (Quairell-Lanoizelée, 2011).

Stakeholder theory has been used in managerial CSR through three aspects (Clarkson, 1995):
1. Descriptive approach, examines the past, present and future states of affairs of organization and stakeholder to generate predictive propositions related to stakeholder management.

2. Instrumental approach, explains the specific links between stakeholder approach and company performance.

3. Normative approach, analyzes the basis of underlying moral and philosophical values.

Heslin and Ochoa (2008) believe that strategic CSR seeks ways to produce a tangible benefit for business while pursuing environmental and social goals. They explain that there are seven strategic CSR principles that organizations can engage in: cultivate needed talent, develop new markets, protect labour welfare reduce environmental footprint, profit from by-products, involve customers and environmentally-friendly supply chain.

Spence et al. (2011) argue that the strategic CSR demands an understanding of the external environment of stakeholders and an analysis on the resources and competencies of the company. Through relating CSR more clearly the company’s competitive values, strategic CSR can be achieved (Strand, 2011). Engagement in strategic CSR should enhance corporate image, boost motivation and loyalty among employees, customers, suppliers and retailers (Lantos & Cooke, 2003).

Peloza and Papania (2008) suggest that managers want to balance between competing stakeholder demands which are not consistent across all firms, demonstrating a form of strategic CSR that is in accordance with the standard norm of the firm or industry.
Waddock and Graves argue that an effective stakeholder relationship can reduce the difficulty in dealing with consumers, community and employees. Firms have to consider a firm’s relationship with a broader set of stakeholders, beyond only shareholders (Fiori et al., 2012) (Arx & Ziegler, 2009).

### 2.2.2 Legitimacy Theory

Legitimacy Theory states that organizations regularly seek to make sure they are perceived as operating adhering to the bounds and norms of their respective societies (Deegan, 2009). Deegan (2009) further asserts that bounds and norms are not fixed, but go through continuous changes. Suchman (1995) posits that legitimacy is a generalized perception that the activities of an entity are desirable, proper or appropriate within a socially established system on norms, values, beliefs and definitions. Legitimacy theory in accordance to the theory of social contract between the organization and the society, that is implicit and explicit expectations the society has on how the organizations should manage its operations (Deegan, 2009). The legitimacy theory relies on the notion of the credibility of a company, which depends on corporate expertise, corporate trustworthiness and corporate likability (Kotler & Keller, 2009).

CSR enables citizens to express the values and influence corporate practices through what they purchase, who they want to work for and where they invest (Baron, 2005). Socially responsible companies have less risks by being more transparent through less risk of bribery and corruption, stricter environmental controls which results in less fines for excessive polluting and lower chances of poor reputation due to child labour or worker safety problems (Tsoutsoura, 2004). For effective CSR, activities conducted
must be available to the public through publishing of reports and engagement must be substantial enough to be considered credible by the society (Godfrey et al., 2008). Management utilizes the annual report as a tool to legitimize ongoing operations of the organization (Brown & Deegan, 1998), to know whether CSR conducted is consistent with society’s demand as compared to companies’ actions.

CSR commitment by companies may lead to an increased ability to attract and retain employees, resulting in reduced turnover, recruitment and training cost (Turban & Greening, 1997). If employee’s personal values and company’s CSR activities are congruent; employee’s trust, loyalty and commitment to the company is enhanced (Tsoutsoura, 2004). Further, Tsoutsoura (2004) explains that in addition to a boost in employee morale, productivity and reduced error rates is also positively affected by commitment to CSR. Brammer and Millington (2005) support the view of enhanced employee attraction through a survey showing employees are more likely to be loyal to companies showing strong CSR tendencies. Turban and Greening (2007) proved in attracting senior managers, a firm’s CSR performance might provide competitive advantage. A survey of MBA attitudes towards potential employers conducted showed that they are willing to work for a lower paid job to be able to work for companies with a more positive social image (Heal, 2004). European Commission (2008) findings also confirm the view by publishing the result of a survey of MBA students in 2008 showing 26% respondents said the potential to make a contribution to society is an essential factor in job selection. Although other factors rank higher, the figure has increased from 15% in 2002.
Companies conducting CSR have improved brand image and reputation, which draws consumers to the product measured by the benefits of advertisement campaigns that indicates enhanced corporate reputation (Tsoutsoura, 2004). Furthermore, empirical research proves that proactive CSR strategies create enhanced corporate credibility and result in positive purchase intentions because companies are perceived to support a good cause (Ven, 2008). Heal (2004) argues that in a market where there is strong competition and small differences in available products, a company’s image can influence customer’s decision. CSR related issues play a role in corporate image and reputation which are determinants of customer satisfaction (European Commission, 2008). Ethical consumerism growth results in consumers gradually factoring environmental and social dimension on purchasing decisions (Quairell-Lanoizelée, 2011). For instance, a certification of environmental management in accordance to ISO 4001 as an element of CSR, can indicate good reputation for corporate environmental activities (Arx & Ziegler, 2009) which will be preferred by socially conscious consumers. Nike and Shell have suffered a loss of sales when low wages paid to developing countries and dispute of oil disposal discovered (Heal, 2004). Meijer and Schuyt findings of Dutch consumers indicate that although CSR do not motivate consumers to buy a product, a minimum acceptable level is necessary to avoid driving away potential consumers (European Commission, 2008). In the US, Europe and Japan, studies have discovered consumers are not willing to purchase product of companies that do not comply with social responsibilities even if the product is cheap (Tanimoto, 2004).

Regulatory decisions in favour of companies with a strong reputation on CSR commitment will be greeted more positively as compared to a company with a failure to
conduct favourable CSR practices. Compliance on CSR activities will determine the regulators decisions, providing improved regulatory protection (Heal, 2004). Socially responsible companies may even have a greater chance of permitting access to cheaper capital (Brammer & Millington, 2005) and exploration permits in areas contested by environmental groups (Heal, 2004).

2.2.3 Institutional Theory

According to Deegan (2009), institutional theory provides an explanation of how organizations aim to align perceptions of practices and characteristics with social and cultural values. Institutional theory provides a complementary perspective to Stakeholder Theory and Legitimacy Theory in understanding how organizations comprehend and respond to changing social and institutional pressures and expectations (Deegan, 2009). Isomorphism, an important dimension of institutional theory is defined as “a constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions” (DiMaggio & Powell, 1983).

There are three types of isomorphic process as explained by DiMaggio & Powell (1983):

1. Coercive isomorphism, arising when organizations change their institutional practices due to pressure from stakeholders upon whom the organizations are dependent.
2. Mimetic isomorphism, emulating or improving institutional practices for competitive advantage in terms of legitimacy.
3. Normative isomorphism, pressures arising from group norms to adopt certain institutional practices.
The institutional isomorphism occurring in CSR practices may be coercive political regulation, normative pressures from professional groups or mimetic process of imitation of similar behaviours in the industry (Jackson & Apostolakou, 2010).

Jackson and Apostolakou (2010) argue that contemporary CSR practices are emerging as a substitute for formal institutions rather than as a strong stakeholder pressure. In sectors where firms have a significant negative impact on stakeholders, companies have a higher tendency to adopt institutionalized forms of CSR (Jackson & Apostolakou, 2010). An explanation of this trend is explained by Deegan (2009) stating that organizations that deviate from standard practices will potentially have problems in gaining or retaining legitimacy. Neo-institutional theory has emphasized on how organizations adopt institutionalized forms of behaviour as an effort to enhance internal and external legitimacy (Jackson & Apostolakau, 2010).

An institutional theory perspective of CSR posits that firms’ decisions on CSR are not purely on instrumental decision-making, but in regard to a broader social context. In liberal market economies where stakeholder involvement is not strongly institutionalized, voluntarily adopting more explicit policies and practices for CSR is done to fill the institutional void (Khanna & Palepu, 2006).

2.3 Corporate Social Responsibility Issues

Although extensive research has proven the benefit of engaging in CSR, some researchers argue that conducting CSR will only result in limited benefit, especially if the motives are merely altruistic. Neoclassical microeconomic supports the view by
emphasizing that operating costs of corporate environmental or social activities can outweigh their financial benefits because shareholder wealth maximization is compromised (Arx & Ziegler, 2009). Moreover, CSR is form of violation of the stewardship principle, since it implies diverting profits for an activity that do not necessarily create value for shareholders (Valor, 2007). Other research claims that although the benefit in the distant future can occur, CSR initially will result in a decrease in profit, reduced firm value and lower shareholder returns (Friedman, 1970). Ioannou and Serafeim (2009) believe that CSR strategies unnecessarily raise a firm’s cost which can create a competitive disadvantage among competitors, and the Economist Intelligence Unit claims that increase in profits are estimated to be insignificant (European Commission, 2008). They argue that employing valuable firm resources for social performance efforts can compromise shareholder payback options which can be spent on better alternative investments for financial benefits.

CSR is a complex multidimensional array of strategies involving environment, community and labour practices concerning a wide range of stakeholder; making implementation and evaluation of CSR strategy complex (Ioannou & Serafeim, 2009). Despite companies’ duty to pay attention to claims of all stakeholders, catering to all demands may be problematic due to conflict of interest between the various stakeholder groups (Boesso & Michelon, 2010). The problem arises because there is no consensus on every single moral standard. Activities considered acceptable or appropriate by one stakeholder can be viewed as immoral by another (Hill et al., 2007). In the case of Microsoft, the company offered benefits to employees in same-sex relationships and supported legislation in the Washington state legislature. Although gay rights interest
groups and many employees deemed the firm to be socially responsible, conservative interest groups viewed the act as socially irresponsible, causing Microsoft to withdraw the support for the bill (Peloza& Papania, 2008). This demonstrates that the idea of what is morally sound is different across society with gray areas on sensitive issues, and corporations have to be aware of the values embraced by the society and reflect it in their CSR activities.

Tsoutsoura (2004) suggests that social issues are best solved by freely elected governments, and distributing the resources of the corporation to address societal problems would be a misallocation of resources. This implies companies are taking over the governmental role for wealth distribution, which can create a lack of accountability (Valor, 2007). Consistent with the views is an article by Friedman (1970) who sees it fit that the state should address social problems, stating that:

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.

Furthermore, managers who pay too much attention on social issues may disregard the primary reason for their existence (Hill et al., 2007).

Another problem of continuous progress for sustainable development is the CSR element of environment. For years, the element of environmental sustainability has been undermined since governments find corporate interest and growth fundamental for the economy. Some governments have allowed firms to generate profit by avoiding environmental costs and use of technologies that disregard the environment. Markets
that fail to recognize environmental cost unless government intervenes and large-scale economic activities that affect the biodiversity of the planet intensify the problem (The Guardian, 2008). The trend shows that the reluctance of countries to engage in proactive stance in environmental issues has lead to less stringent laws by the government. Environmental laws that are less strict worsen the problem in developing countries, and present concerns of “race to the bottom” environmental standards to compete with each other in attracting foreign investors (The Economist, 2001). Worldwide trends have shown governments protecting the economy by sacrificing the environment. Developed nations are hesitant to target major emissions cuts beyond 2012, the year the Kyoto Protocol expires, without emerging developing nations willingness to curtail emissions. China, India and Brazil have chosen stances that demonstrate they are not committed yet to enter a binding international agreement on reducing emission (Reuter, 2011). This problem is further exacerbated by the Eurozone financial crisis hitting European nations, but having a global affect. Fourteen out of 27 countries in the European Union have public debt of more than 60% of Gross Domestic Product at 2010 with Greece Italy, Belgium, Ireland and Portugal topping the debt league (CNN, 2010). The Eurozone has faced social distress by losing 185,000 jobs in one month with over 450,000 more people unemployed than on the beginning of 2012 (The Telegraph, 2012). For firms to be in line with the notion of sustainable development, the balance of economic, environmental and social elements is crucial. Hence, governments have to be more strict in regulation of environmental laws that allows the pursue of economic gains without destructing the environment and social stability.
2.4 Corporate Social Responsibility Elements

The elements of CSR according to Elkington’s view of the triple bottom line concept of sustainability are as follows (Deegan, 2009):

1. Economic, focusing on short-term possibility on generating profit for the business to survive in a competitive environment.
2. Society, focusing on the medium-term aspect which recognizes the notion that businesses operate within a society, and negative impacts on societal functions can threaten profitability.
3. Environmental, focusing on long-term issue of the environmental sustainability, which is imperative for both social and economic sustainability as the economy and all social systems operate within the natural environment.

Caroll believes CSR can be categorised into four groups (Oeyono et al., 2011):

1. Economic responsibility, referring to the fundamental duty of a business to produce goods or services the society wants, and sold at profit.
2. Legal responsibility, referring to the obligation of a business to accomplish economic missions within the framework of legal requirements.
3. Ethical responsibility, referring to the ethical responsibilities of corporations that go greater than the legal requirements.
4. Discretionary responsibilities, referring to voluntary responsibilities that a company can engage in albeit the lack of clear-cut societal expectations.
2.5 Approaches to Corporate Social Responsibility

Companies have various stances of engagement in CSR activities due to different perspectives of management and the extent of requirement of companies standard within the industry. The spectrum of CSR practices according to Ebert and Griffin (2007) fall between these four categories, which is in order of the lowest socially responsible firms to the highest level of social responsibility:

1. Obstructionist Stance, an approach of CSR which involves doing as little as possible as an attempt to deny or cover up violations. Companies choosing this stance usually have minimum concern on ethical conduct and make an effort to conceal wrongdoing. For instance, IBP a leading meat-processing firm that is known for breaking environmental protection, labour and food processing law has gone to great lengths to hide the offenses they commit.

2. Defensive Stance, companies that choose this approach will meet minimum requirements of commitment in meeting socially responsible duties to groups and individuals. Corporations taking the defensive stance are less likely to hide or deny failure to comply with CSR standards and will take corrective actions. For example, tobacco companies in the United States usually engage in this approach of CSR where they are legally obliged to include warnings of smoking and limit advertising to prescribed media.

3. Accommodative Stance, companies that adopt this approach meet its legal and ethical requirements but will also exceed minimum requirements in certain cases if asked to do so. The characteristics of such firms suggest that they do not proactively seek avenues for contributing, like in the case of Shell and IBM that
match contributions made by employees to selected charitable causes. However, in order to do so companies must be convinced that the given program is worthy to be supported.

4. Proactive Stance, the most CSR aware firms engage in this practice, which refers to companies that actively seek opportunities to contribute to the well-being of groups or individuals in its social environment. Commonly, corporations set up a foundation to provide direct financial support for various social programs. For example, UPS underwrites training and travel cost of employees competing in the Olympics, and also allows flexibility in work schedules for the athletes.

The approaches are not always clearly distinct (Ebert & Griffin, 2007), organizations do not always fit in one particular category. A company may have a proactive stance in social-related policies but an obstructionist stance in environmental policies. Although UPS seem to have a genuine motive in helping athletes compete, the company can feature the athlete’s photos in its envelope and promote the company itself (Ebert & Griffin, 2007). In Indonesia, although Sampoerna Foundation’s contribution on tertiary education through joint CSR budget has been deemed as effective CSR (Urip, 2010), the impact of the tobacco industry on the social and environmental level must be examined as well.

2.6 Corporate Social Responsibility Rating

In order to evaluate a company’s environmental and social impact, stakeholders need to be aware of the full range of firm’s activities; however, a lack of access and expertise to analyze information can cause difficulty (Lyon & Maxwell, 2006). CSR ratings are
produced by rating agencies, in-house research teams, providers of securities indices, NGOs with expertise on CSR, media, public authorities and management (Bertlesmann Foundation, 2006). This section will focus on how CSR rating agency analyzes the performance of social and environmental aspects of a company.

CSR rating agency is an organization that assesses corporation’s performance in accordance to the standard of social and environmental performance and nonfinancial data (Scalet & Kelly, 2010). Social ratings serve the purpose to supply social investors accurate information and increase transparency of examining a firm’s past and future outlook of social and environmental performance (Chatterji et al., 2007). Rating agencies study CSR reports, administer surveys, analyze media report, engage in independent investigation and communicate with management of rated corporations to generate a quantitative analysis of a company’s sustainability performance (Scalet & Kelly, 2010).

The methodologies of CSR rating agencies involve subjective weighting of each CSR dimensions’ importance, resulting in difficulty to compare results across rating agencies due to heterogeneous data and lack of standardisation (Belu & Manescu, 2009) (Scalet & Kelly, 2010) (Schäfer, 2005). Although the rating schemes and methods differ, CSR agency ratings globally have the following elements that recur in the model: dichotomy of sustainable leader and pioneer, stakeholder approaches, value management, long-term perspectives and output features (Schäfer, 2005).
The following CSR rating institutions are explained to gain an idea of how assessing sustainability performances of companies are conducted (Bertelsmann Foundation, 2006).

### 2.6.1 Kinder Lydenburg Domini (KLD Research & Analytics Inc.)

KLD provides a global research and index of companies to aid the integration of environmental, social and governance factors into the investment process. This rating institution believes that CSR ratings enable investors, managers and fiduciaries to influence greater accountability of corporate behaviour by investment decisions and share ownership.

KLD ratings use possible strengths and concerns as a proprietary framework to assess social, environmental and governance performance. Companies are rated in seven major qualitative issue areas: environment, community, corporate governance, diversity, employee relations, human rights, product quality and safety.

### 2.6.2 Sustainable Investment Research International Company Ltd. (SiRi)

The main concern of SiRi is the principle of sustainable development and the stakeholder model. According to SiRi, a company that does not acknowledge the importance of ecological and social responsibility will encounter long-term risks.

The relevant information of a company is summed up in a company profile called the SiRi Global Profile. The criterion used to measure sustainability is based on business ethics, community, corporate governance, customers, employees, environment, contractors and human rights.
2.6.3 CoreRatings

CoreRatings is a CSR-rating agency connected to a finance or credit rating agency, which is established in the international capital markets to assess the largest global companies. They focus on risk-oriented vision of sustainability, based on an investor’s point of view.

The company’s assessment is based on a three-step model including: identification of specific risks in environmental, social and ethical areas; investment risks and company assessment of policy development policy implementation; validation and assurance, performance as well as transparency and disclosure.

2.6.4 Sustainable Asset Management Group Holding AG (SAM)

SAM allows the identification of successful companies meeting sustainability criteria through systematic research. SAM’s expertise include an independent research, active sustainability network worldwide as well as developing and managing sustainability-oriented investment products.

The rating system of SAM follows three fundamental steps which is the analysis of macro trends and industry challenges; a corporate sustainability analysis involving screening, assessing and focused analysis of economic, environmental and social dimension and finally the determination of sustainable fair value.

2.7 Corporate Social Responsibility Framework

Several guidelines have been established to aid reporting of social and environmental performances that relies on the “one size fits all” approach (Deegan, 2009). The
appropriate measure of CSR which the accounting guidelines adopt take into account the factors that constitute social responsibility and independent characteristics of an organization, based on measures of outcome rather than perceptions and reflect the values of the stakeholders (Peloza & Papania, 2008). This section will explain various guidelines available for sustainable conscious firms to adopt in their business.

2.7.1 SA8000

The SA800 standard focuses on international workplace norms of International Labour Organization conventions, the Universal Declaration of Human Rights and the UN Convention on the Rights of the Child. Companies use the standard as a benchmark to measure the performance and compliance with policies and procedures to protect the basic human rights of workers. The following elements are the requirements to comply with SA8000 (Social Accountability International, 2008):

1. Child Labour: No use or support of child labour, written procedures or remediation of any child found to be working, sufficient financial and support to allow such children to attend school and employment of young workers conditional.

2. Forced and compulsory Labour: No forced labour; no withholding salary, benefits or documents of personnel by employers; uphold personnel right to leave premises after workday; respect right to terminate their own employment and no support of human trafficking.

3. Health and Safety: Provide a safe and healthy work environment; ensure prevention of potential injuries; existence of system to detect, avoid, and respond
to risk; decrease risks to expectant mother and access to toilet and potable water.

4. Freedom of Association and Right to Collective Bargaining: Uphold the right to form and join trade unions and bargain collectively and where law prohibits these freedoms, assist means of association and bargaining.

5. Discrimination: No discrimination based on race, national or social origin, caste, birth, religion, disability, gender, sexual orientation, union membership, political opinions and age. No discrimination in hiring, remuneration, training, promotion, termination and retirement.

6. Disciplinary Practices: Treat every personnel with dignity and respect through a policy of zero tolerance for corporate punishment, mental or physical abuse or inhumane treatment.

7. Working Hours: Comply with applicable law and industry standards, normal workweek excluding overtime shall not exceed 48 hours with one day off every six work day and overtime is voluntary.

8. Remuneration: Wages paid must meet legal minimum wage to meet basic needs, no disciplinary deductions and overtime paid at a premium rate.

9. Management Systems: Facilities seeking to gain and maintain certification must exceed simple compliance to integrate the standard into their management systems and practices.

2.7.2 AA1000

AA1000 principles are intended to be used by an organization to develop an accountable and strategic approach to sustainability by understanding, managing and improving sustainability performance. It acknowledges the demand for an organization to actively
engage with stakeholders, identify and understand the sustainability issues that impact the performance of a company. The three AA100 principles (AccountAbility, 2008) are:

1. The foundation principle of inclusivity: To be accountable to whom it has an impact or who have an impact on it, to engage in stakeholder participation and have required competencies and resources to address stakeholder issues.

2. The principle of materiality: To determine the relevance and significance of an issue to an organization and stakeholders, to consider the sustainability drivers and account for needs of organization and have a determination process of materiality that fairly represents issues from a wide range of sources.

3. The principle of responsiveness: To respond in a comprehensive and a balanced way; to addresses the needs, concerns and expectations of stakeholders when responding; and timely responses by the organization.

2.7.3 Global Reporting Initiative

The purpose of Global Reporting Initiative (GRI) is to serve as a generally accepted reporting framework for the organization’s economic, environmental and social performance. It is designed to be utilized by organizations of any size, sector or location. Furthermore, the framework is agreed among a wide range of stakeholders for an indicator of sustainability performance with a diverse range of stakeholders considered: business, labour, non-governmental organizations, investors and accountants. GRI suggest three different types of disclosures should be followed (Global Reporting Initiative, 2011):
1. **Strategy and Profile:** Disclosures on organizational performance including the strategy, profile and governance.

2. **Management Approach:** Disclosure on how organizations tackle sustainability concerns.

3. **Performance Indicators:** Provide comparable information of economic, environmental and social performance of the organization.

Core indicators are generally applicable indicators assumed to be material for most organizations, developed through GRI’s multi-stakeholder process. Additional indicators reflect emerging practices that are material for some organizations, but not material for others. The six key topics are Economic Performance, Environmental, Labour Practices, Human Rights, Society and Product Responsibility. GRI explains the six key topics that reflect the concerns through stakeholder engagement. The elements of performance indicators for GRI are presented in detail in the *Appendix* section in table 2.1.

Becker (2009) believes that due to the increasing concern of incorporating labour practices, corruption, environment and human rights issue, the adoption of CSR framework such as GRI has become essential.

White (1999) argues that the benefit of GRI includes the consideration of major stakeholders in creating the framework, embracing the concept of standardization in CSR reporting and a standard that exceeds traditional framework such as mere environmental and health safety concerns. Further, he explains that the inclusion of accountants in the creation of the framework enables a standard that is firmly grounded in standard accounting principles of relevance, reliability, understandability,
comparability, timeliness, verifiability which most companies focus on when creating a financial report.

According to Nikolaeva and Bicho (2011), GRI promotes and develops a standardized approach to meet the demand of sustainability reporting. This allows the company to gain legitimacy as being responsible corporate citizens through complying with the norms of the industry, a part of fulfilling the institutional theory. Firms adopting GRI seek to use CSR reporting as a reputation management tool to meet pressures from stakeholders and an integral part of communicating the corporate identity. GRI does not challenge existing organizational structures but complement the existing cooperation practices.

Based on past GRI studies conducted and the widespread adoption of adhering to GRI practices, this study uses GRI as a framework to measure CSR.

2.8 Definition of Operating Performance

Operating performance is an indicator of cash generating capability, a measure of an analytical indicator of leverage capacity, financial performance and planning purposes (PR Newswire, 2007). Operating performance indicates a firm’s internal process and systems to strive for steady progress which should be altered depending on the environment and economy conditions (Vokurka & Fliedner, 1995). Yozzo et al (2001) believe operating performance can be utilized as historical time-series as a benchmark for performance in competing companies. Luang (2010) further explains that operating performance represents the competitive advantage, that is the strategic process employed by the company.
Analysis of profitability, specifically operating performance in this research, is essential as it concerns with three important stakeholders: the stockholders, creditors and management. Stockholders obtain revenue in the form of dividends and capital gains that can arise due to increased profits resulting in an increase in the market price, an indicator of how well management convert the money they invest to generate income. Creditors are interested in knowing if source of funds will fulfil the debt coverage. Management uses profitability as an indicator of a company’s performance measure (Gibson, 2009).

2.9 Measurement of Operating Performance

Investors, shareholders and management are concerned with which management strategies or system enables the decrease in cost and boost sales since it indicates the firm’s performance (Rennings et al., 2003). Performance measurement serves as an aid in developing strategic plans, evaluating achievement of corporations’ objectives and compensating managers (Venanzi, 2010). Multiple ways are available to quantify operating performance in a company, which is explained in this section. In addition, this section will also explain why this thesis uses Return on Asset as an indicator of operating performance.

2.9.1 Stock Price

According to Bacidore et al. (1997) a measurement of wealth creation that relies on stock price seek to establish the increase of shareholder’s wealth from one period to another depending on the dividends received or increase in the corporation’s stock price.
A stock price reflects the market’s opinion about the firm’s entire future stream of operating performances.

The main criticism of using stock price as an indicator of firm’s operating performance is the assumption that markets are efficient. The theory of efficient market hypothesis states that prices of securities in financial markets entirely reflect all publicly available information (Mishkin & Eakins, 2005), hence show the performance of a firm. However, due to different access to resources, knowledge and expertise, not all information is available equally for all the participant of stock trading in the market. Thus, stock prices cannot entirely be used by managers to assess their cost of capital or performance accurately, because the assumption of efficient market hypothesis has some weaknesses (Mishkin & Eakins, 2005):

1. Small firm effect, markets did not appear to be efficient in the case of small firms where empirical studies have shown that despite a greater risk to invest in such firms, abnormally high returns has been gained over a long period of time.

2. Market overreaction, research by Werner and Thaler argue that stock prices may overreact to news announcement and pricing errors are adjusted slowly. When a firm announce a great change in earnings, the stock prices may rise significantly. After an initial great decline, to rise to normal levels will require several weeks.

3. New information is not always immediately incorporated in stock prices, stock prices do not instantly change when there is an announcement of higher profit. On the contrary, on average stock prices rise some time after the announcement of high profits, and they continue to fall after low profit announcements.
4. Disposition effect, tendency of investors to sell winning stock too early and hold losing stocks too long. Despite the information available in the market, market does not react as quickly as how the efficient market hypothesis believes it to be. Investors are risk-averse in gains and risk-seeking in losses, thus they will sell winning stock in order to cash in on sure gains and hold on to losing stock to avoid a certain loss (Deegan, 2009).

2.9.2 Economic Value Added

A modified version of residual income where accounting adjustments are done to produce economic income and economic capital from a given accounting income and accounting capital is called Economic Value Added (EVA). EVA is calculated using three variables that is the return on capital earned on investment, the cost of capital and the capital invested (Venanzi, 2010).

EVA is the gain or loss that is left after levying a charge against after-tax operating profit for the opportunity cost of all capital, that is equity and debt to generate profit. The basic notion of EVA lies on the principle that until a business returns a profit that is more than the cost of capital, it operates at a loss. The idea is not practiced in measurement of conventional accounting profits which includes a deduction for interest payments on debt but no provision on the cost of equity capital (Ehrbar, 1999).

EVA links the firm’s accounting data with the stock market performance with an ability to predict abnormal return. It is utilized for resource allocation and compensation purposes. The EVA balance sheet represents the value of the assets more accurately than
the balance sheet created by firm’s accountants; however, it does not indicate the total value of the firm and the value of future opportunities (Bacidore et al., 1997).

Merchant and Stede (2007) point out the weaknesses in EVA measurement:

1. Accuracy problems, because the EVA adjustments are ad hoc, managers can introduce bias to the decision-making instead of basing choices on accounting numbers and the real condition of the company.

2. Understandability problems, since the measures are not traditional and rather complex, some consulting firms have decided not to use EVA as a measurement of profit since the understandability problem results in faulty decisions.

3. Expensive, EVA demands assistance from consultants as well as management development and training time which is not a solution for firms that have a highly constrained budget.

The strengths and weaknesses of EVA according to Venanzi’ research is presented in table 2.1

<table>
<thead>
<tr>
<th>Strengths of EVA</th>
<th>Weaknesses of EVA</th>
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<tr>
<td>- Focuses on how a firm’s make in excess of cost of capital</td>
<td>- It could be inconsistent with value creation. A firm could be generating positive EVA for assets in the current year and have a negative EVA in the future year, making the assets poor investment</td>
</tr>
<tr>
<td>- Helps firms filter projects that is value destroying, that is small earnings project</td>
<td>- Too complex for front-line managers to use to motivate managers to reduce capital expenditures</td>
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<td></td>
<td>- Provide few information for long-term drivers of firm value</td>
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(Source: Venanzi 2010)
2.9.3 Return on Asset

Ratio analysis includes a set of financial ratios such as profitability ratio, liquidity ratio and solvency ratio. Ratios are interpreted through a comparison made with prior ratios, ratios of competitors, industry ratios or predetermined standards. Additionally, in understanding the ratio it is important to recognize trends as well as variability of the data. In this study, the profitability ratio will be used, specifically Return on Asset (ROA). ROA is defined as a measure of a firm’s earning ability, used as an indicator for operating performance in this research. ROA measures the firm’s ability to utilize its assets in order to obtain profit by using a given amount of asset of the firm. The higher the figure of ROA indicates a higher efficiency of the firm to produce more income from the assets they own (Gibson, 2009).

Assets such as cash, equipment and property are owned by a company to increase the profitability and future wealth of a business. Hence, it can be understood that assets are investments in future profit, and interpreting the effectiveness of assets can be used to evaluate the creation of profit. In order to improve ROA, a firm can increase net income without acquiring new assets or enhance the effectiveness of existing assets. Thus, it is imperative that the management have the expertise to manage assets effectively and efficiently to improve the company’s operating performance (Ewing Marion Kauffman Foundation, 2006). Net income is used in calculating ROA since it is influenced by operating decisions and how the firm is financed (Keown et al., 2005), which can convey a firm’s operating performance.
ROA is an appropriate measurement that includes all the critical influences of a company’s asset management, economic growth potential and an indicator of improving company performance. Further, ROA reflects the company’s ability to generate profit through productive use of resources and efficient management (Burja, 2011). Burja’s research attempted to explore the factors of profitability, and used ROA as an indicator of operating performance.

When measuring operating performance, ROA reflects the general use of profitability ratio and its overall ability to measure the effectiveness of capital used (Dooley & Lerner, 2004). ROA was extensively used by various researchers to represent operating performance such as Hull and Rothenberg; Mahoney and Roberts; Waddock and Graves; Lee et al.; D’Arcimoles and Trebucq; Aras et al.; Bhagat and Bolton; Fernandez-Sanchez and Sotorrio. They argue that it represents the profitability of the firm in respect to the total set of resources, or assets, under its control (Karagiorgos, 2010).

Bauwhede (2009) believes ROA is a good indicator for operating performance since operating income is not determined by discretionary items than the income calculated through return on equity or net profit margin such as income before extraordinary items. Another research also supported the view that ROA is a widely accepted measure of firm’s performance and used extensively in the strategy formulation (Ashok and Kunal, 2003).

ROA measures the profitability of companies expressed in the amount of net earnings after the interest payments and taxes per unit of assets (Belu & Manescu, 2009). Belu
and Manescu used ROA when measuring how CSR impacts the company’s operating performance.

ROA is the broadest indicator of after tax profitability, due to the fact that the denominator takes into account the total assets of the companies. Consequently, ROA is the most reliable data on a company’s profitability because it is not influenced by the specific conditions of a company related to branch affiliation or short-term consideration of its owners regarding the size of the capital (Ivan, 1999).

2.10 Determinants of Operating Performance

Nugent (1998) argues that the factors influencing profitability, which can indicate operating performance is competitiveness of an industry, internal demand of company’s product, degree of concentration in industry, exchange rate variables and external demand. The degree of concentration is included under the belief that the greater monopoly power enjoyed by the company, the greater profit margin it will be able to generate as it controls a large amount of the market share. Exchange rate and external demand are also incorporated since Nugent believes that profitability is pro-cyclical and changes are a result of the economic growth rate.

Belu and Manescu (2009) suggest that operating performance is determined by several factors including the firm’s size, leverage, capital intensity, retained earnings, sales, price-to-book ratio and dividends-to-book ratio. The study by Belu and Manescu follows the previous study findings on 2007 conducted by Manescu and Starica where the determinants are comprised of the same factors.
Research conducted by Wernelfelt and Hansen (1998) revealed that the determinants of profitability, reflected through a good operating performance, is influenced by three factors:

1. Characteristics of the competition in the industry the firm operates in. A large part of the reasoning includes industry growth, industry concentration, capital intensity and advertising intensity, which contribute to the degree of competitiveness of the industry.

2. The firm’s performance as compared to its competitors. Market share indicates a firm’s performance relative to competitors since it is perceived as the source of market power and can be used as a proxy for a firm’s competitive advantage.

3. The quality or quantity of the firm’s resources. This can explain a firm’s size or reflect the range of diversification efforts engaged by the company.

Ashok and Kunal (2003) state that the determinants of operating performance is comprised of three factors: Market flexibility, an indicator of market share and market presence of the company; Production flexibility, showing revenues from a common product of the company and Competitive flexibility, that is the global coverage in which the business market its product.

Bauwhede (2009) explains the determinants of operating performance include good governance practices, size of company and natural logarithm of assets. The research shows that the variables mentioned can influence the operating performance of the companies, using ROA as in indicator of operating performance.