Corporate Social and Financial Performance

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The effect of corporate social responsibility (CSR) on agency problems can be explained from two perspectives. If managers use CSR activities to reduce information asymmetry between managers and shareholders, CSR activities will also alleviate the agency problem between managers and shareholders. Therefore, the interests between managers and shareholders will align in firms where the agency problem is low, and the manager's efforts on CSR will increase corporate financial performance (CFP). On the other hand, if managers use CSR activities as an opportunistic tool to promote information asymmetry, CSR activities will intensify the agency problem. The interests between managers and shareholders are conflicted in firms where the agency problem has deepened, and the manager's efforts on CSR will lower CFP. Consequently, the effect of corporate social performance (CSP) on CFP will vary depending on managerial incentives to engage in CSR activities.

Keywords: corporate social performance ; corporate financial performance ; firm life cycle ; large business groups

1. Background

A manager is just an economic man who acts reasonably to obtain maximum profits according to economic theory. Managers with an edge over business information have substantial discretionary power that allows them to achieve their goals and thus are more likely to drive CSR activities to their advantage [1][2]. Since managerial discretion can affect the agency problem in two directions, an increase or decrease, the effects of these two opposite forms depend on the business situation that the managers face. Managers act in their best interests to maximize their wealth and minimize the risk of dismissals [3][4][5]. If managers believe that reducing agency problems helps them achieve their goals, they will engage in CSR activities to reduce agency problems. Otherwise, they will use CSR activities to deepen the agency problem.

The firm life cycle (FLC) theory divides the evolutionary process into several stages and argues that the business environment, organizational structure, and management strategy are different across the FLC stages [6][7]. According to this theory, firms at the introduction and growth stages would actively expand their market share, secure competitive advantage, and increase facility investment. However, mature firms that focus on production efficiency would reduce costs and improve capacity utilization. Firms at the decline stage would choose a strategy to withdraw from existing businesses, such as disposing of unnecessary facilities in response to a decrease in market demand. Therefore, the business situation that managers can face, and the conflicts between managers and shareholders would vary across FLC stages [8]. In a life cycle stage where the interests between managers and shareholders are aligned, managers will engage in CSR activities to alleviate the agency problem, and CSP would contribute to enhancing CFP. On the other hand, in a life cycle stage where the interests between the managers and shareholders are not aligned, managers will engage in CSR activities to conceal opportunistic behavior, and CSP would have a negative effect on CFP. Overall, the relationship between CSP and CFP can be affected by the intensity of the agency problem across FLC stages [9][10][11][1][2].

While corporate ownership in Western countries (e.g., the United States and the United Kingdom) is diffuse, corporate ownership in Asian countries is concentrated [1][12][13][14]. Thus, the separation of ownership and control barely exists for Korean firms. The agency problem in Korean firms arises from conflicts between controlling and minority shareholders [1][2][15][16]. Furthermore, Korean firms belonging to a large business group called a "Chaebol" are closely intertwined with each other via pyramidal ownership structures and cross-holdings. Thus, the controlling shareholders of Chaebols are more likely to engage in tunneling activities that benefit them at the expense of other shareholders [1][2][17][18][19]. The agency problem may be more severe in Chaebols than in non-Chaebols, and the sensitivity between CSP and CFP would be more pronounced in Chaebols. Previous studies have overlooked that the mixed results on the relationship between CSP and CFP may be attributed to the FLC and large business groups that can affect the intensity of the agency problem.

2. Corporate Social and Financial Performance

This study uses agency theory as the primary theory lens to examine the relationship between CSP and CFP. There are still conflicting views on the relationship between CSP and CFP. First, from the positive perspective, managers can use CSR activities to reduce information asymmetry between managers and shareholders [9][10][11][1]. CSR activities will thus alleviate the agency problem between managers and shareholders. High CSP relieves concerns of external monitors, such as activists, shareholders, and NGOs [20], and enhances corporate reputation [21]. In addition, CSR activities can facilitate corporate innovation by easing regulatory pressures, and thus they will help expand business scope [22][23]. Orlitzky et al. [21] argue that the reputation improved by CSR activities increases the future CFP. Choi et al. [10], Cho et al. [11], and Lev et al. [22] claim that the manager's efforts in CSR contributes to future sales growth by reducing information asymmetry. Dhaliwal et al. [24] find that the managers involved in CSR activities tend to voluntarily disclose a lot to highlight the positive image of the firm, thereby reducing information asymmetry. Benlemlih and Bitar [9] document that high CSR involvement increases investment efficiency. Platonova et al. [23] prove that CSR disclosure improves future financial performance by alleviating information asymmetry. Park and Lee [1] reveal that the long-term managerial incentive for compensation reduces the agency problem and thus enhances the positive relationship between CSP and CFP. Therefore, the interests between managers and shareholders will align in firms where the agency problem is not severe, and the manager's efforts in CSR will increase CFP. However, from a negative perspective, managers can use CSR activities as an opportunistic tool to promote information asymmetry [25][26][27][28]. CSR activities would thus intensify the agency problem. These socially responsible activities can lead to the misuse of resources in the process of satisfying the conflicting interests of managers and shareholders, which can reduce corporate performance [29]. Hemingway and Maclagan [25] argue that managers can use CSR activities to hide corporate misconduct or mismanagement. McWilliams et al. [27] suggest that the manager's efforts for CSR may lead to the misuse of resources that would be returned to shareholders. Prior et al. [28] argue that managers engage in CSR to cover up opportunistic earnings management. Kim and Venkatachalam [26] claim that managers in sin industries (e.g., gaming, tobacco, alcohol, and adult entertainment, etc.) engage in CSR activities to improve the negative image of the sin firm. Krüger [29] finds that investors react negatively to good CSR news which may result from agency problems. Overall, if high CSP helps alleviate the agency problem, it will have a positive effect on enhancing CFP. However, if CSR activities create a severe agency problem, it will have a negative impact on CFP.

3. The CSP–CFP Sensitivity and Firm Life Cycle Stages

Strategic choices for corporate growth vary across FLC stages. CSR activities could be directed as a management strategy used by a firm to moderate the agency problem between managers and shareholders. Thus, the relationship between CSP and CFP would vary across FLC stages. Specifically, the business situation that a firm faces at each stage is as follows: firms at the introduction stage are usually small in size and do not have much financial capacity, making it difficult to differentiate products through business diversification and innovation [30][31]. Their financial performance also fluctuates or incurs losses, resulting in lower CFP than those at other FLC stages [6][32]. They cannot afford to invest in CSR activities, and their future sustainability is uncertain. Managers may engage in CSR activities to hide opportunistic behaviors, deepening the agency problem. Thus, the weights of CSP on CFP is smaller than those of other FLC stages. Firms at the growth stage may be innovators that succeeded in finding their market among the firms at the introduction stage. They increase sales and employment through product diversification and innovation [7][8][32]. Thus, they still must invest in infrastructure to maintain high growth and returns [33] and evaluate managers in the long-term perspective [34]. They also invest heavily in CSR activities to reduce the agency problem, and CSP begins to be reflected significantly in CFP. Firms at the mature stage adopt strategies for long-term growth due to more sustainable revenue than firms at other FLC stages [25][4][7]. They increase efficiency in the production process through accumulated know-how and knowledge, resulting in the highest profitability among all life cycle stages [6][32][35]. Thus, they continue to invest in CSR activities to alleviate the agency problem, and the extent to which CSP affects CFP is greater. Firms at the shake-out stage do their best to find new growth opportunities, as growth rates slow down sharply [6]. If they fail to find new growth opportunities, they experience a steep fall in the growth rate and face considerable uncertainty on whether they can continue as a going concern. Thus, they do not invest heavily in CSR activities, and CSP has less impact on CFP. Firms at the decline stage did not find any further growth opportunities in the market, resulting in a decline in their market share, worsening profitability, increased debt, and decreased liquidity [6][7][32]. They focus on restructuring or merging with other firms by reducing operating costs rather than growth-oriented investment [7][36]. They invest very little in CSR activities, and even if they do, they use them to achieve opportunistic goals. Therefore, CSP does not lead to an increase in CFP. Miller and Friesen [7] argue that firms tend to move in a linear progression through the five life cycle stages. Govindarajan and Shank [35] explain the FLC using the product portfolio matrix and emphasize the importance of the management control system to carry out strategies for each life cycle. Anthony and Ramesh [36] find that the market reaction to accounting performance is a function of the FLC stage. Koberg et al. [33] attempt to explain why the innovativeness of a firm changes as the FLC develops. Black [32] finds that the informativeness of earnings and cash flow measures differ across FLC stages. Dickinson [6] argues that future profitability differs across FLC stages. Consequently, the CSP–CFP sensitivity varies depending on the effect of CSP on the agency problem for each FLC stage.

4. The CSP–CFP Sensitivity and Chaebol Firm Effects

Unlike firms in Western countries where the agency problem traditionally arises from conflicts of interest between managers and shareholders ("Agent–Principal" conflicts), the agency problem in Asian firms arises from those between controlling and minority shareholders ("Principal–Principal" conflicts) [1][2][12][14][16]. In Korean firms, where ownership is not separated from control, the controlling shareholder can either directly act as a manager or appoint a manager whom they can control. Therefore, the controlling shareholder can exercise significant influence over corporate management. This unique feature is prominent in Korean Chaebol firms owned by families and makes it easier for owner-managers to exploit other shareholders. Chaebols indicate, in strict terms, a large business group subject to the regulations of the Korean Fair Trade Commission to prevent the concentration of economic power via pyramidal ownership structures and cross-holdings among affiliated firms. The controlling shareholders of Chaebols can exercise greater voting rights than cash flow rights and are more likely to pursue their interests by using the wedge between voting rights and cash-flow rights. However, controlling shareholders cannot overlook the importance of CSR as they have an incentive to run a firm from a long-term perspective. Therefore, CSR activities can be a safety device to alleviate the agency problem between controlling and minority shareholders.

If managers of Chaebols engage in CSR activities to achieve opportunistic goals, CSR activities only incur costs that intensify the agency problem and reduce CFP [11][1][37]. On the other hand, if they use CSR activities to reduce information asymmetry in the long-term perspective, CSR activities will alleviate agency problems and increase CFP. However, the controlling shareholders of Chaebol firms have been known to create a severe agency problem by engaging in tunneling activities that benefit them at the expense of other shareholders. Bae et al. [17] prove that the controlling shareholders of Chaebols benefit from acquisitions by tunneling activities. Baek et al. [19] find that Chaebol firms tend to sell their securities at lower prices when the controlling shareholders in the issuing firms can gain benefits from selling securities at a discount. Bae and Jeong [18] show that the value-relevance of earnings and book value is significantly smaller for Chaebol firms. Park [2] reveals that managerial influence to reduce audit quality is higher among Chaebol firms. Park and Lee [1] show that the short-term incentive for compensation that exacerbates the agency problem drives the sensitivity of CSP to CFP in Chaebol firms. Taken together, Chaebols are passive to CSR, and the cost of CSR activities do not contribute to the increase in CFP. The CSP–CFP sensitivity will be relatively lower in Chaebol firms, and this sensitivity will depend on the FLC stage.

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