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When doing good pays off : the nonlinear u-shaped effect of CSR on financial performance of indonesian listed companies

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ABSTRACT

The study investigates the non-linear correlation between the financial performance of companies that are listed on the Indonesia Stock Exchange and their commitment to Corporate Social Responsibility (CSR). It uses the Driscoll-Kraay method in a Fixed Effect regression model with panel data from 145 companies over the years 2019–2023. The findings show that there is a U-shaped relationship between CSR and Return on Assets (ROA), whereby CSR first reduces ROA before eventually increasing it above an ideal level. Nevertheless, there was no discernible relationship between Return on Equity (ROE) and CSR. Growth, leverage, and company size all had a consistent effect on both financial performance metrics. These results offer insightful information for creating CSR plans that take into account both immediate and long-term financial consequences. The study underscores the significance of employing a variety of financial performance indicators when assessing the impact of corporate social responsibility (CSR) and stresses the necessity of adopting a comprehensive approach to comprehending the intricate correlation between CSR and corporate financial performance.

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INTRODUCTION

Social and environmental activities were initially considered as external factors separate from corporate business activities. However, social activities started to have a big influence on the company's business operations along with the growing awareness and demands of people all over the world for more environmentally and socially responsible business practices (Malik et al., 2015). The growing awareness of social and environmental issues among consumers is one of the primary motivating factors. When making purchases, consumers are increasingly taking into account ethical business practices (Ahmadi & Mahargyani, 2024). Businesses who don't live up to these standards run the risk of seeing a decline in sales and a bad reputation. For instance,

campaigns to boycott products from businesses engaged in labor exploitation or environmental degradation are becoming more and more common (Jalil et al., 2020). Conversely, companies that implement socially and ecologically conscious business practices stand to benefit from a number of competitive advantages, including enhanced client loyalty, simpler hiring and retention of top talent, and access to new markets and resources (Roszkowska-menkes, 2020). Businesses are also encouraged to implement sustainable business practices by pressure from regulators and investors (Arı et al., 2023).

The connection between corporate financial performance (CFP) and social responsibility (CSR) is still up for debate in academic research, though (Galant & Cadez, 2017). Prior studies that attempted to investigate this relationship in a linear fashion yielded varying and frequently inconsistent results. External research indicates a positive correlation between CSR and CFP (Margolis et al., 2012; Orlitzky et al., 2003), but other studies find a negative correlation (S. J. Brammer et al., 2011; Simerly, 1997), or no significant correlation at all (Soana, 2011). The unclear nonlinear relationship between CSR and financial performance could be the cause of these contradictory findings. The stakeholder theory, which was put forth by Freeman, (1984) , lends credence to the argument for a positive relationship. According to this theory, businesses that effectively implement CSR can strengthen their relationships with stakeholders, including customers, employees, and communities. However, the argument against a positive relationship between CSR and CFP is rooted in the belief that allocating resources to CSR initiatives can raise a company's operational expenses, particularly in the near future, thereby diminishing profitability and financial performance (S. Brammer & Millington, 2008). Furthermore, some businesses might be more concerned with accomplishing short-term financial objectives than long-term environmental and social objectives (Friedman, 2007).

In order to address the constraints of linear research, certain researchers have initiated an investigation into the potential existence of a nonlinear correlation between CSR and the CFP of a company (Barnett & Salomon, 2018; S. Brammer & Millington, 2008). They contend that when corporate social responsibility (CSR) is initially low, increasing CSR can potentially enhance a firm's financial performance by bolstering its reputation and legitimacy. Nevertheless, when corporate social responsibility (CSR) reaches higher levels, additional increments in CSR could potentially lead to a decline in financial performance due to the costs involved surpassing the benefits obtained. This viewpoint is substantiated by a study conducted in India (Cordeiro et al., 2021) which discovered a curvilinear U-shaped correlation between CSR and CFP. The rationale behind this is that companies must make substantial investments in order to build the necessary capability to effectively influence stakeholders. Companies that possess a greater *stakeholder influence capacity* (SIC) will achieve higher and more favorable financial returns once they have reached the minimum SIC threshold (Barnett & Salomon, 2018). In contrast, a study conducted in China discovered an *inverted U-shaped* relationship between corporate social responsibility (CSR) and financial performance. This means that at lower levels of CSR, there is a positive correlation between CSR and CFP, but then once the optimal point is reached, this relationship becomes inverse (Pu, 2023).

The concept of CSR is a relatively recent concept in Indonesia and its progress has not been as extensive as in other developed nations. The relationaship between CSR and financial performance in Indonesia is complex and varies based on firm characteristics and industry sectors. Firm size, ownership structure, leverage, age and international exposure significantly influence this relationship (Waagstein, 2011). Industry-wise, extractive sectors often show stronger positive relationships due to their environmental and social impacts (Pondrinal, 2021), while manufacturing, financial services, consumer goods sectors exhibit varying relationships depending on specific factors (Arli & Tjiptono, 2014). While the concept of Corporate Social Responsibility (CSR) has been in existence, it was not until 2007 that regulations mandating companies to adopt CSR practices were introduced under the Limited Liability Company Law.

(Ahyani & Puspitasari, 2019). Consequently, the study of corporate social responsibility (CSR) in Indonesia remains constrained and has yet to explore more intricate factors, such as the nonlinear correlation between CSR and CFP. The majority of research conducted in Indonesia regarding the correlation between CSR and CFP primarily examines a linear relationship. This includes investigations into both positive relationships (Ahyani & Puspitasari, 2019; Pondrinal, 2021), and negative relationships (Dewi & Muslim, 2022), or even no relationship (Puspita & Kartini, 2022). There aren't many studies that explicitly examine the nature of the nonlinear relationship since few researchers have thought about the possibility of a nonlinear relationship. Thus, studying the nonlinear relationship between financial performance and corporate social responsibility has not been an area of great interest for Indonesian researchers. The importance of investigating the nonlinear relationship between CSR and financial performance in Indonesia has increased as a result of the country's rapidly changing business landscape and the increasing emphasis on sustainability. Indonesia's economy is expanding and diversifying, and there is a growing consciousness of environmental and social concern (Waagstein, 2011). This transitions has resulted in regulatory modifications, including the implementation of mandatory CSR for specific sectors, emphasizing the necessity of comprehending the complex consequences of CSR that extend beyond mere complience (Rosser & Edwin, 2010). The significance of corporate responsibility has been further underscored by the Covid-19 pandemic, necessitating an understanding of the impact of CSR initiatives during crises on long-term performance (Djalante et al., 2020). In order to satisfy the increasing social consciousness of Indonesian consumers and investors, companies must enhance their CSR strategies while simultaneously preserving their financial stability (Arli & Tjiptono, 2014). It is crucial to undertake nonlinear research on the correlation between CSR and financial performance in Indonesia, with the purpose so that Indonesian companies can enhance their CSR strategies to achieve maximum financial and social advantages by comprehending the intricacies of this intricate relationship.

RESEARCH METHOD

This study utilizes financial performance data extracted from the financial statements of companies listed on the Indonesia Stock Exchange (IDX) for the duration of 2019 to 2023, encompassing a span of five years. The panel data is sourced from Capital IQ, a financial data and business intelligence platform offered by S&P Global Market Intelligence. With reference to 91 disclosure items, CSR score data employs proxy scores derived from CSR disclosures based on GRI standards. With 725 firm years of initial data and 712 firm years of final observations, 145 companies make up the entire sample. The Return on Equity (ROE) and Return on Asset (ROA) ratios are used to measure financial performance as dependent variables, while for independent variable is using the Corporate Social Responsibility (CSR) disclosure data, which was sourced from each company's annual Sustainability Report for the previous five years. Company age (AGE), revenue growth (GROWTH), current ratio (LIQ), leverage (LEV), and size (SIZE) were used as control variables for this research. The operationalization of measurements in this work is described below:

Tabel 1. Measurement Variables

Variable	Definition	Measurement
ROA	*Corporate Financial Performance Measure:* Return on Assets (ROA) ratio which is derived by dividing net income by total assets, illustrates how well the business manages its resources to turn a profit. The financial performance of the company improves with a higher ROA	$ROA = \frac{Net\ Income}{Total\ Assets}$

ROE	the return on equity (ROE) ratio assesses how well a business can produce net income from its shareholders' equity	$ROE = \frac{Net\ Income}{Total\ Equity}$
	Corporate Social Responsibility Measure:	
CSR2	The CSR value squared to account for nonlinear influences	CSR x CSR
	Control Variables:	
LEV	Debt to Equity Ratio for each company	$\text{LEV} = \frac{Total\ Debt}{Total\ Equity}$
AGE	the years since the company was established	AGE = Log (years)
GROWTH	Total Revenue	Growth = Log (Total Revenue)
LIQ	Current Ratio for each company	$\text{LIQ} = \frac{Current\ Assets}{Curernt\ Liabilities}$

In order to verify whether employing the Fixed Effect (FE) panel data regression model is more feasible than the Random-Effects (RE) model for panel data, this study uses the Hausman test in conjunction with the FE model (Hausman, 1978). This study first tested multicollinearity in accordance with the classical assumption test, and then it employed the Woolridge method for autocorrelation testing and the Breusch-Pagan method for heteroskedasticity testing.
The estimated equation that is used to test the hypothesis is:

$$Financial\ Performance_{it} = \beta_0 + \beta_1 CSR_{it} + \beta_2 CSR^2_{it} + \beta_3 SIZE_{it} + \beta_4 LEV_{it} + \beta_5 LIQ_{it} + \beta_6 GROWTH_{it} + \beta_7 AGE_{it} + U_{it}$$

The nonlinear (curvilinear) impact of CSR on financial performance is captured by coefficient β_2, whereas the linear effect is captured by coefficient β_1. An inverted U-shaped relationship between CSR and financial performance is indicated if β_2 is significant and negative, with an optimal point for CSR being reached when financial performance reaches its maximum. On the other hand, a U-shaped relationship between CSR and financial performance is indicated if β_2 is significant and positive, with an optimal point for CSR occurring when financial performance reaches a minimum. Mathematically the extreme point is calculated with $-\beta_1/2*\beta_2$, where it represented the CSR level at which the impact on financial performance shifted from negative to positive (Nollet et al., 2016). Alternatively, extreme point can be seen in the U-test result. Utilizing a Fixed Effect model enables the researcher to manage unobserved heterogeneity among firms, which could introduce bias in the estimates if not properly addressed (Vu et al., 2019). Fixed effects account for firm-specific factors that remain constant over time, resulting in a more precise estimation of the correlation between CSR and financial performance.

RESULTS AND DISCUSSIONS

Table 2 displays the outcomes of descriptive statistics for all variables following the application of winsorization to certain variables that are deemed to possess extreme values (Wilcox, 2005). To address outliers, a 1% winsorization technique is applied to the ROA, LEV, and LIQ variables, while a 5% winsorization technique is applied to the ROE variable. Winsorizing is applied to the financial ratios of ROA, ROE, LEV, and LIQ because these variables can exhibit extreme values as a result of significant fluctuations in profits or losses. Additional variables are not winsorized as they are deemed to lack extreme values.

Table 2. Descriptive Statistics

	Obs	Mean	Std. Dev.	Min	Max
ROA, Winsorized fr..01	720	3.383	9.735	-35.85	34.137
ROE, Winsorized fr..05	720	5.595	13.131	-26.062	30.155
CSR	725	23.16	3.894	12.088	35.165
SIZE	723	12.229	1.707	6.192	27
LEV, Winsorized fr..01	714	.628	1.34	-4.222	7.264
LIQ, Winsorized fr..01	720	2.708	3.38	.096	24.804
GROWTH	718	11.932	1.958	.384	27
AGE	725	4.767	.403	2.792	6.333

The regression model selection is conducted using the Hausman test and incorporates winsorized variables. The Hausman test results indicate that in Model 1, the probability is 0.000, and in Model 2, the probability is 0.0274. This probability is smaller than 0.05, suggesting that the Fixed Effect (FE) model is preferred over the Random Effect (RE) model. In order to ensure the dependability of the regression model, the classical assumption test is subsequently conducted. The multicollinearity test indicates that the Variance Inflation Factor (VIF) value is 2.347, which is below the threshold of 10. This suggests that there are no significant multicollinearity issues among the independent variables. A heteroscedasticity test was performed on both models using the Wald test. The test result for both models, Prob>chi2 = 0.0000, indicates that the models do not pass the heteroscedasticity test, meaning that there is no homoscedasticity present in either model. The Wooldridge test for panel data is used to conduct an autocorrelation test. Model 1 exhibits a Prob>F result of 0.000, which is less than 0.05, indicating the presence of autocorrelation. On the other hand, Model 2 with a Prob>F value of 0.2086 does not suggest the existence of autocorrelation as the value exceeds 0.05. In addition, the Driscoll-Kraay standard errors regression model for the Fixed Effect Model is employed to test the hypothesis. The outcomes of this analysis are presented in Table 3.

Table 3. Driscoll-Kraay regression results

	(Model 1) ROA	(Model 2) ROE
CSR	-2.35972***	-.81383
	(.49818)	(.65372)
CSR^2	.04249**	.01743
	(.00979)	(.01303)
SIZE	-3.333**	-5.98102***
	(.91309)	(.69571)
LEV	-.19434	-4.90821***
	(.55423)	(.34338)
LIQ	.3007	.19391
	(.15713)	(.14419)
GROWTH	2.00834*	5.14968***
	(.78467)	(.53225)
AGE	16.3562**	-5.60486
	(5.64422)	(5.23899)
_cons	-27.27761	55.96089
	(31.4789)	(33.00719)
Observations	712	712
Prob > F	0.0001	0.0000
Pseudo R^2	0.0712	0.2817

Standard errors are in parentheses
**** p<.01, ** p<.05, * p<.1*

The regression analysis of Model 1, using the Driscoll-Kraay method, revealed an intricate correlation between Corporate Social Responsibility (CSR) and the company's financial performance, as measured by Return on Assets (ROA). The statistically significant negative β_1 coefficient (-2.360) and positive β_2 coefficient (0.042), both significant at the 1% level, suggest a U-shaped nonlinear association between Corporate Social Responsibility (CSR) and Return on Assets (ROA). This corroborates and acknowledges the hypothesis. The findings indicate that during the early phase, an escalation in CSR endeavors generally leads to a decline in financial performance. However, once a specific threshold is reached, this correlation shifts to a positive one.

The study revealed that the size of a firm has a notable adverse impact on its return on assets (ROA), suggesting that larger firms generally exhibit lower ROA. Conversely, the age of a firm exhibits a notable positive correlation with return on assets (ROA), suggesting that older firms generally demonstrate superior financial performance. The growth of the firm has a positive impact on the return on assets (ROA), although this impact is only statistically significant at the 10% level. Surprisingly, there is no notable correlation between leverage and liquidity with return on assets (ROA) in this particular model. The regression model demonstrates statistical significance, however, it only accounts for approximately 7.12% of the variability in ROA. This implies that there are additional factors beyond the model that may influence the financial performance of firms. Unlike Model 1, the regression analysis of Model 2 using Driscoll-Kraay demonstrates that the variables CSR and CSR do not have a statistically significant impact on ROE. The p-values for β_1 (-0.814) and β_2 (0.017) are 0.281 and 0.252 respectively, indicating that they are significantly higher than the conventional significance level. This suggests that in this model, there is not enough evidence to determine whether there is a linear or non-linear correlation between CSR and ROE.

Then to get more robust results, a U-shaped test was carried out to assess the presence of a U-shaped correlation between CSR and financial performance. The U-shaped test conducted on Model 1 yielded a p-value of 0.0228, providing support for the regression results indicating a U-shaped relationship between the CSR and ROA variables. The pronounced negative slope at the lower boundary (-1.332) and the notable positive slope at the upper boundary (0.629) provide evidence for the U-shape. The extreme point (27.7652) falls within the range of values being tested, providing further evidence for the U-shaped pattern. This represents the turning point in the U-shaped curve where the effect of CSR on financial performance shifts from negative to positive. This suggests that the impact of CSR on financial performance is not linear but rather complex and dynamic. Table 4 displays the results. In addition, the U-shape test of Model 2 yields a p-value of 0.159, suggesting that there is insufficient evidence to substantiate the presence of a U-shape. In this scenario, there is a direct and unchanging relationship between CSR (Corporate Social Responsibility) and ROE (Return on Equity). Investing in CSR consistently affects financial performance, without any specific point where the advantages of CSR start to decrease or reverse.

Table 4. U-shaped Test

	(Model 1)		(Model 2)	
	Lower bound	Upper bound	Lower bound	Upper bound
Interval	12.088	35.165	12.088	35.165
Slope	-1.332	0.629	-0.393	0.412
t-value	-4.953	2.866	-1.14	1.457
P>t	0.004	0.023	0.159	0.109
Extreme point	27.7652		23.35122	
t-value	2.87		1.14	
P>t	0.0228		0.159	

The findings of this study significantly enhance the theoretical comprehension of the correlation between Corporate Social Responsibility (CSR) and corporate financial performance.

The discovery of a non-linear, U-shaped correlation between Corporate Social Responsibility (CSR) and Return on Assets (ROA) in Indonesian companies strengthens the stakeholder theory, which posits that proficient management of stakeholders can enhance financial performance. This supports the findings of prior studies (Barnett, 2007; Cordeiro et al., 2021). The non-linear nature of this relationship demonstrates the complex and intricate connection between CSR and financial performance.

CONCLUSION

After examining two research models on the U-shaped Nonlinear Effects of CSR on Financial Performance, it can be inferred that the connection between CSR and financial performance is intricate and changes based on the performance metrics employed. Model 1 demonstrates the presence of a U-shaped nonlinear correlation between CSR and Return on Assets (ROA). This suggests that initially, an escalation in CSR activities can lead to a decline in ROA, but once the optimal point is surpassed, additional increases in CSR actually result in an improvement in ROA. At lower levels of CSR (below the extreme point), increases in CSR activities may initially have a negative impact on financial performance, possibly due to the costs associated with implementing these initiatives. However, as CSR efforts approach and surpass the extreme point, their impact on financial performance becomes increasingly positive. This transition indicates that there's a threshold level of CSR engagement beyond which firms start to reap financial benefits from their social responsibility efforts. Conversely, Model 2 does not demonstrate a substantial correlation between CSR and Return on Equity (ROE), suggesting that the impact of CSR on ROE may be intricate or indirect. Additional variables such as the size of the company, its level of debt, and its rate of growth consistently demonstrate notable impacts on various indicators of financial performance. The disparity in outcomes between the two models underscores the significance of taking into account diverse metrics of financial performance when assessing the influence of CSR. These findings suggest that companies should adopt a more comprehensive CSR strategy, considering the trade-off between CSR investment and short and long-term financial performance expectations. Investors should take into account a company's Corporate Social Responsibility (CSR) initiatives as a potential determinant of Return on Assets (ROA), while also considering other relevant factors. Policy makers should implement incentives or regulations to motivate companies to exceed the optimal level of their corporate social responsibility (CSR) activities.

Corporate managers and executives should take note of the significant implications of this study. It reveals that while the initial investment in corporate social responsibility (CSR) may not yield an immediate increase in return on assets (ROA), there comes a threshold where the financial benefits become more evident. Managers should be ready to "persist" through the initial phase where Return on Assets (ROA) may decrease. Furthermore, the disparity in outcomes between Return on Assets (ROA) and Return on Equity (ROE) implies that managers should not solely depend on a single performance metric when assessing the influence of Corporate Social Responsibility (CSR). It is necessary to adopt a comprehensive approach when evaluating the performance of a company, taking into account various financial and non-financial indicators. Furthermore, due to the intricate nature of the relationship between corporate social responsibility (CSR) and financial performance, it is imperative for managers to devise proficient communication strategies in order to elucidate the enduring worth of CSR investments to shareholders and other stakeholders. This is particularly crucial when the immediate effects of such investments may be unfavourable. Lastly, managers are responsible for overseeing and controlling both internal and external expectations regarding the outcomes of corporate social responsibility (CSR). It is important to highlight that the advantages of CSR initiatives may not be immediately apparent in financial metrics, but they can contribute to the long-term viability and worth of the company.

However, this study does have certain limitations. Emphasizing solely on Return on Assets (ROA) and Return on Equity (ROE) may not offer a comprehensive assessment of financial performance. The proposition of a U-shaped correlation may oversimplify the intricacy of the relationship between corporate social responsibility and financial performance. Furthermore, the results may be influenced by constraints in the measurement of corporate social responsibility (CSR) and the duration of the study. To address these limitations and advance our understanding of CSR's impact, future research should focus on developing more robust and comprehensive CSR measurement methods. This could include creating more nuanced CSR indices, leveraging machine learning for analysis of corporate reports, and implementing industry-specific standardized metrics. Additionally, researchers should consider incorporating a wider range of variables such as stakeholder perceptions, long-term inpact measures, and more precise environmental and social impact indicators.

Importantly, future studies should explore CSR's influence on non-financial aspects of corporate performance. CSR initiatives can significantly affect a company's reputation, potentially leading to enchanced brand value and public trust. This improved reputation can, in turn, foster customer loyalty, as consumers increasingly favor companies that demonstrate strong ethical and social commitments. Employee performance and satisfaction may also be positively impacted by CSR efforts, as workers often experience increase motivation and engagement when they perceive their company as socially responsible. These non-financial outcomes, while challenging to quantify, can have substantial long-term effects on a company's success and sustainability. By addressing these areas, future research could provide more nuanced and comprehensive understanding of the relationship between CSR and both financial and non-financial performance metrics. This would not only advance academic knowledge but also offer more actionable insights for managers and policymakers, helping to bridge the gap between CSR theory and practice. Such research could guide companies in developing CSR strategies that balance short-term costs with long-term benefits, both financial and non-financial, ultimately contributing to more sustainable and responsible business practice.

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