Integration of Corporate Social Responsibility (CSR) and Corporate Governance: A Conceptual Framework

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Abstract

Objective: The present paper presents a conceptual framework for the integration of Corporate Social Responsibility and Corporate Governance to create a more comprehensive approach i.e. Environmental, Social and Corporate Governance (ESG).

Method and statistical analysis: Secondary data is used to understand the linkage between environmental, social and corporate Governance

Findings: Companies as a part of society are responsible for its actions and play an important role in a process of sustainable development. Increasing concerns of the stakeholders of the companies towards the company's affairs and actions make the companies to think and rebuilt their strategies. Corporate Social Responsibility and Corporate Governance are linked to get a clearer picture of the operations of corporate social responsibility with in the corporate regulations.

Application/Improvements: More and more research on ESG in developing economies is emerging. It is required to understand the emergence of the concept of ESG. Examination of the two important terms CSR and CG and their integration into ESG could propagate flawed understanding of the concepts.

Keywords: conceptual framework; corporate social responsibility; corporate governance; environmental, social and corporate governance (ESG)

Introduction

In recent times, there has been an increase in corporate sustainability reporting, to address the increasing concerns of the stakeholders. It has become a common phenomenon for listed companies, to report on the various ESG issues. Stakeholders are interested in the transparency of its corporations regarding its material ESG issues along with the other financial issues (Siew, Balatbat and Carmichael, 2013). The global impetus around responsible investing which includes ESG investing has made the corporations aware of the impact of these non monetary issues on their success. Due to this, various companies are exploiting the risks and opportunities related to the ESG issues to their advantage and this in turn has become a matter of concern for the investors. Concerns regarding emissions, depletion of natural resources, water scarcity, issues due to strikes and disputes of employees illustrate environmental and social issues. However various corporate frauds and scams such as Enron, WorldCom illustrate the need of governance in corporations. These ESG issues are being incorporated in the mainstream investment by the institutional and retail investors.

Increasing concern and awareness of institutional and retail investors towards ESG Investing is a reflection of its growing acceptance. This trend is irreversible and for good reasons (Jeroen Bos, 2014). The increasing trend of investment in sustainable and responsible funds has been documented for the last three years. A report by Global Sustainable Investment Review, 2016 shows the region-wise growth of Socially Responsible Investment (SRI) assets for the period 2014-16. A remarkable growth can be observed from Table 1.1 over the period 2014-16 in all the regions. The total growth is 25.2% and compound annual growth rate is 11.9%, indicating the growth in the SRI fund market.

Table 1.1: Growth of SRI Assets by Region 2014-2016

Region	2014	2016	Growth over period	Compound annual growth rate
Europe	$ 10,775	$ 12,040	11.7%	5.7%
United States	$ 6,572	$ 8,723	32.7%	15.2%
Canada	$ 729	$ 1,086	49.0%	22.0%
Australia/New Zealand	$ 148	$ 516	247.5%	86.4%
Asia ex Japan	$ 45	$ 52	15.7%	7.6%
Japan	$ 7	$ 474	6689.6%	724.0%
Total	**$ 18, 276**	**$ 22,890**	**25.2%**	**11.9%**

Source: Global Sustainable Investment Review, 2016

This growth in SRI assets show the investor's incorporation of material ESG issues into their investment consideration.

Corporations aware about this change are hence focusing on their non financial information and doing their best to communicate this, along with the financial information, to its investors and other stakeholders (Breuer and Nau, 2014). In fact the market interest is also growing in the non financial information (Eccles and Serafeim, 2011). Thus the non financial information with regard to environment, social and governance is becoming important to communicate by corporations to its stakeholders.

The materiality of information in financial reporting can be well described by the regulatory bodies whose guidance generally exists within a set of clearly defined standards and principles (Eccles and Rogers, 2012). However over the last decade, the materiality of non financial information has risen to the fore. The ESG performance of any company eventually impacts its performance due to which investors and portfolio managers are considering them in their decision making process. The materiality of ESG factors and issues into investment decision making is well described in the Figure 1.1.

Sharma & Dangwal (2015) describes that the materiality of ESG factors can be demonstrated from the recent events related to ESG issues and its relationship with financial performance. ESG factors can be used to select better managed companies that can mitigate risks and which avoid exploiting the opportunities stemming from the key environmental and social issues (Briand, Urwin and Chia, 2011). The materiality of ESG factors may depend on the nature, size and location of a company. It is also possible that one factor which is material for one company or sector may not be material for another. Recent events related to environment such as release of leak of cyanide at Aurul, Gold Mining Co. in 2000, oil spill at

British Petroleum in 2010, radioactive material at Tokyo Electric Power Co. in 2011 etc., similarly events related to social issues such as child slave labour at Nestle in 2012, wage dispute at Lonmin plc in 2012 and various corporate scams such as Olympus, Satyam, Lehman Brothers, WorldCom etc have impacted investments in their own way.

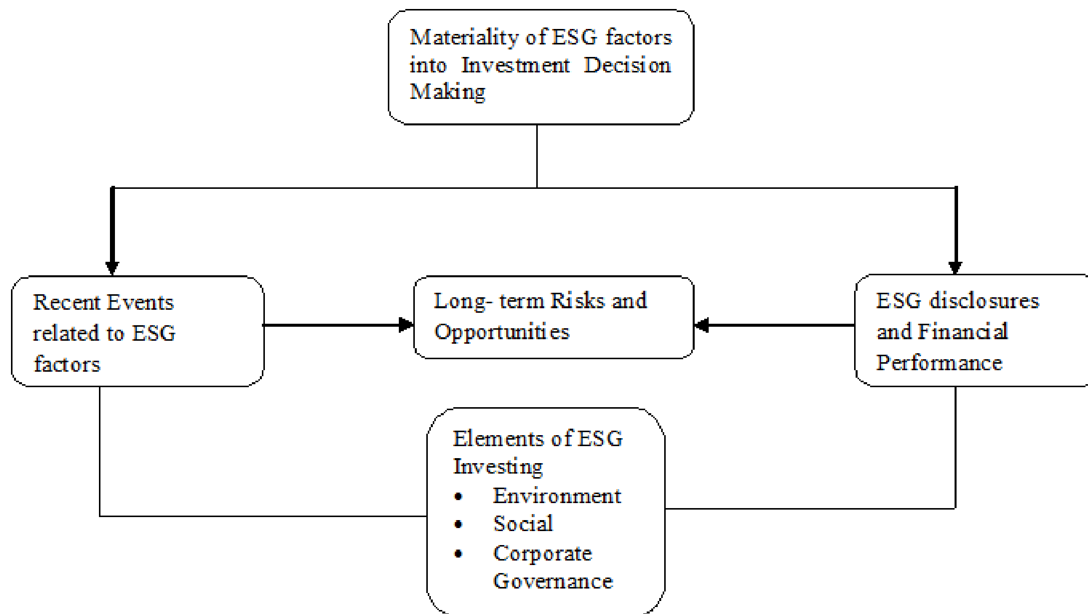

Figure 1.1: Materiality of ESG Factors into Investment Decision Making
Source: Sharma & Dangwal (2015)

However we find a vast literature indicating positive correlation between ESG disclosure and financial performance of companies. Generally materiality of non financial information (ESG factors) arises in two ways: Recent events related to ESG and Relationship between ESG disclosures and financial performance. The main purpose of this paper is to present a conceptual framework for the integration of corporate social responsibility and corporate governance.

Review of Literature

Corporate Social Responsibility (CSR)

Archie B. Carroll in his study “A-Three Dimensional Conceptual Model of Corporate Performance” in the year 1979 described the broader concept of CSR by formulating a conceptual model on social performance. According to him, social responsibilities can be categorised into four groups: Economic Responsibilties, Legal Responsibities, Ethical Responsibities and Discretionary Responsibilties. The economic responsibility of business firms includes the production of goods and services and sell them at profit. The business firms has obligation towards the rules and regulations and should perform its activites with in the legal framework shows the legal responsibility. The ethical responsibilty covers the duties which are beyond the rules and regulations of the society and the voluntary deeds of business firms to benefit the society called discretionary responsibility. The study concludes that management must address

the social issues like environemental, consumerism and discrimiantion into its consideration. But Carroll's four domains of CSR and pyramids of CSRhave amended bySchwartza and Carroll (2003) with an alternative approach to CSR "Three-Domain Model of CSR". The proposed model eliminates the separate philanthropic category and sub-sumes it within the economic and/or ethical spheres. It was proposed by the researchers that the new model portrays the relationships between the three central CSR domains: economic, legal, and ethical. Corporate CSR reporting is the way to convey information about the CSR activities and practices of companies to its stakeholders and other interested parties (Yin and Zhang, 2012). Branco and Rodrigues (2008) suggested that companies with higher visibility exhibit greater concern to improve corporate image through social responsibility disclosures both on the Internet and in annual reports. Even the material information related to CSR practices and strategies of corporations may affect the investors' and asset managers' recommendations.

Corporate Governance (CG)

Numerous studies examined the level of corporate governance practices of corporations and its significance in the investment and corporate world. In his conceptual and exploratory study,Mayer (1997) examined the role of governance systems in disciplining management and restructuring poorly performing companies, finance and investment, commitment and trust and found that the main differences in financial systems may concern the formulation, implementation, and adaptation of corporate strategy rather than incentives, disciplining, finance, and investment. Shleifer and Vishny (1997) explored corporate governance practices and assessed the role of legal protection of investors and ownership concentration in corporate governance system across the world and found the legal protection of investors and concentration of ownership as complementary approaches to governance.SimilarlyHillman and Dalziel (2003) argued that board capital affects both monitoring and the provision of resources and a board's incentives moderate the relationship between board capital and provision of resources. The researchers categorised the functions of corporate directors into two parts: Agency Theory and the Monitoring Function. The primary function of boards according to the agency theory is to monitor the actions of agents (managers) to protect the interests of principals (owners). On the other hand, monitoring function relates with number of specific activities such as monitoring CEO, monitoring strategy implementation, planning succession and evaluating and rewarding the CEO/top managers of the firm.

A good governed company has fairer financial results over the poor governed company. That's why corporate governance practices of corporations considered as an important element of communication for its stakeholders. For instance the study of Farber (2005) indicates that fraud firms have poor governance relative to a control sample in the year prior to fraud detection and also found that analyst following and institutional holding do not increase in fraud firms. Similarly Bhat, Hope and Kang (2006) used a sample of non-US firms cross-listed in the USA as American Depositary Receipts (ADR) from the period 1992 to 2002 and found that governance transparency is positively associated with analyst forecast accuracy after controlling for financial transparency.

There have been approaches which explained the CSR and CG in a specified manner. However the studies which provide conceptual integration of CSR and CG are very few. The present paper presents a conceptual framework for the integration of Corporate Social Responsibility and Corporate Governance to create a more comprehensive approach i.e. Environmental, Social and Corporate Governance (ESG). Corporate Social Responsibility and Corporate Governance are linked to get a clearer picture of the

operations of corporate social responsibility in corporate regulations. A good research is available on the individual study of these concepts, however many studies also found a strong interlink between the CSR and CG (Jamali, Safieddine and Rabbath (2008), Kolk and Pinkse (2009)). Therefore the next sections define the concepts of CSR and CG and their convergence into ESG.

Corporate Social Responsibility (CSR) andCorporate Governance (CG) – The Relevant Concepts of Framework

Corporate Social Responsibility (CSR)

CSR is an obligation of corporations for their actions in the society where they exist and the impact of their actions whether in a positive or negative way. They are responsible for their deeds in the environment and society. The traditional concept of CSR as a philanthropic activity has changed into the modern concept of CSR which is more comprehensive and extensive. It was Archie B. Carroll who contributed the broader concept of CSR in 1979 by suggesting four kinds of social responsibilities which constitute total CSR: economic; legal; ethical and philanthropic. He formed a pyramid of CSR according to the four responsibilities which is shown in Figure 1.2. CSR is defined as the actions which are beyond the interest of companies but for social interest such as human resource management programs, recycling, abating pollution, supporting local businesses etc. (McWilliams and Seigal, 2001). It is defined as the responsibilities of corporations towards societies for their actions (Narwal and Singh, 2013). Through CSR activities companies having negative reputation can change their bad image (Saleh, Zulkifli and Muhamad, 2011).

Thus, **CSR consist two important factors: Environmental factors and Social factors**.

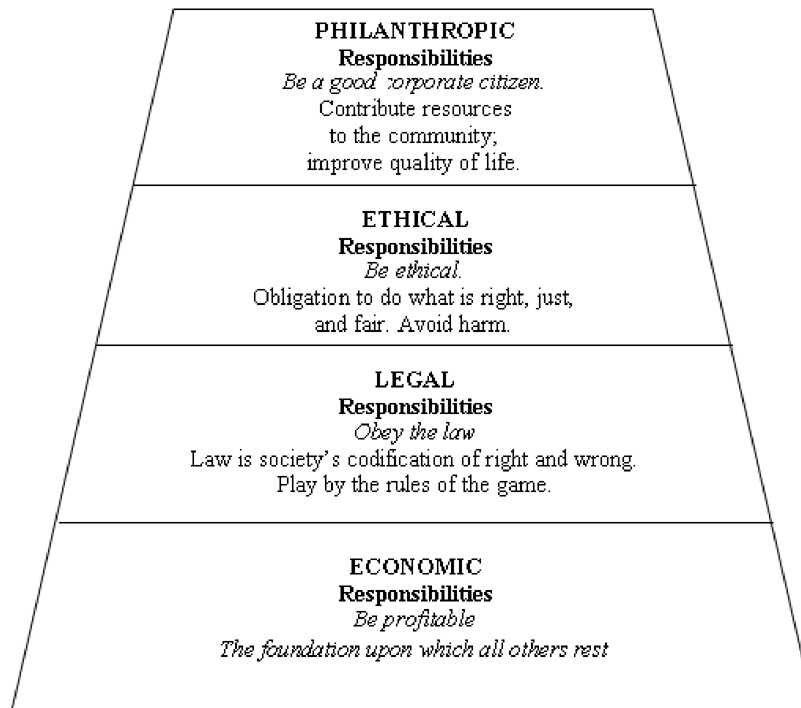

Figure 1.2: The Pyramid of Corporate Social Responsibility (CSR)
Source: Carroll (1991)

It is the responsibility of the corporations towards its stakeholders and the environment in which they exist to protect them and provide sustainable business in favor of shareholders, employees, customers, community, government and environment. Modern concept of CSR is much broader than the traditional one which was solely based on charity and social welfare.

United Nations Industrial Development Organisation (UNIDO) defined CSR,*"asa management concept whereby companies integrate social and environmental concerns in their business operations and interactions with their stakeholders."*

Triple Bottom Line or Triple Performance Line further illustrates the concept of CSR. This concept focuses on the three core dimensions of CSR: Economic; Environmental and Social. It says that a company should measure its performance in relation to its stakeholders including local communities and governments not just those stakeholders with whom it has direct and transactional relationships such as employees, suppliers and customers (Agnieszka Zak, 2015). Environmental issues include emission, wastes, water discharge, resource reduction etc. and social issues include employee retention, strike issues, health and safety issues, human rights impacts, impact of operations on community, product safety and responsibility etc.

Corporate Governance (CG)

One of the most important characteristics of a company is the separation of ownership from the management, putting the responsibility of business and its operations on its board of directors. A framework and guidelines has been stipulated for corporations to report and disclose the performance and affairs of company to their owners. Corporate governance is a system or a set of rules and regulations, through which the owners of the company oversee the internal affairs of the company, manage the directions and control over the company stimulating more transparency and disclosures. Corporate governance is defined by Cadbury Committee of U.K. as "*the system by which companies are directed and controlled*."According to Confederation of Indian Industry (CII) Desirable Corporate Governance Code (1998), *"corporate governance deals with laws, procedures, practices and implicit rules that determine a company's ability to take informed managerial decisions vis-à-vis its claimants – in particular, its shareholders, creditors, customers, the State and employees. There is a global consensus about the objective of 'good' corporate governance: maximizing long-term shareholder value."*

The concept of corporate governance is based on several important theories such as Agency theory; Stewardship theory; Stakeholder theory; and Stakeholder-Agency theory (Kumar, 2012). The **Agency Theory** is based on the concept of separation of ownership and control. Under this theory, the company's owners who are the shareholders set its objectives and appoint managers as their agents to pursue their objectives. Managers (agents) run the company on behalf of the owners (principal) (Kumar, 2012). The **Stewardship Theory** of corporate governance is based on the assumption that managers act in a trustworthy manner and put in their efforts honestly on behalf of the owners for the company. They work efficiently to attain higher level of profit for the company. The **Stakeholder Theory** is a much broader concept than the others which is based on 'social contract' theory wherein the organisations are

accountable to its stakeholders such as investors, employees, suppliers, customers, community, government, etc. (Kumar, 2012). In order to achieve the long term benefits, organisations must be concerned about all their stakeholders. The **Stakeholder-Agency Theory** is an integrated model in which the business looks after the concerns of its shareholders (investors) along with its stakeholders (investors, employees, suppliers, customers, community, government, etc.).

In modern economies, a prominent feature of a large corporation is the separation of capital providers (owners) and resource managers (management) (Cheung and Chan, 2004). Thus, it is necessary to monitor and control the behaviour of the management for the purpose of transparency and disclosure. Corporate governance is a framework within which a company has to follow the given rules and regulations and be accountable to its stakeholders. The issues related to governance are issues related to board diversity, remuneration, related party transactions, different committees such as audit committee, stakeholders committee, nomination and remuneration committee, board meetings and attendance etc.

Integration of CSR and CG

The integration of the two concepts CSR and CG has changed the world of corporate reporting. Both practices of corporations impact its financial performance and are relevant from the managerial perspective, as well. Nowadays corporate governance is not merely about the rules and regulations for corporations to protect the interest of its investors, but it encapsulates a much broader concept. It also includes transparency, disclosures, accountability and ethics (Breuer and Nau, 2014). There are other stakeholders besides shareholders who have a vested interest in the business's actions and hence accountability should be extended to them too. Thus, CSR and CG are both influenced by stakeholder theory (Money and Schepers, 2007). The companies having good environmental, social and governance performance influence shareholders value. They can manage risks; anticipate regulatory actions, or access new markets and at the same time they also contribute to sustainable development of the societies in which they operate (Standberg, 2005). New governance has been adapted with transparency, accountability, ethical norms along with including CSR into business practices by corporations (Gill, 2008). In fact mainstream investors and asset managers are taking these CG and CSR factors into consideration while taking investment decisions. Hence the measurement of the ESG performance of corporations is as relevant as their financial performance.

"The growing number of codes of conduct, best practices, and guidelines initiated by businesses, regulators and administrative agencies serve as a primary source of business regulation. At this juncture, New Governance finds its strongest expression in the field of corporate conduct as it encompasses two of the most important socio-legal patterns that enable the convergence of corporate governance and CSR: self-regulation and meta-regulation" (Gill, 2008).

Thus, the term new governance which can also be called as environment, social and corporate governance includes legal and regulatory framework of business along with sustainable and social business.

Concept of Environment, Social and Governance (ESG)

A number of non monetary factors contributing to the performance and value of a company are mostly excluded from the financial statements of the company (Stubbs and Rogers, 2013). These factors are related to the environmental, social and governance issues such as climate change, water scarcity, social

issues, strikes, child labour, community issues, board diversity, disclosures, transparency and equity. There is no universal definition for ESG factors and issues. ESG factors or issues are the three central factors or issues i.e. environment, social and governance which are created by company's actions and influence stakeholders' decision making.

"Environmental, social and governmental (ESG) factors are indicators used to analyse a (investee) company's prospects based on measures of its performance on environmental, social, ethical and corporate governance criteria (OECD, 2017)."

According to the *Principles for Responsible Investment (2016),* Environmental issues are the issues relating to the quality and functioning of the natural environment and natural systems such as biodiversity loss; greenhouse gas (GHG) emissions, climate change, renewable energy, energy efficiency, air, water or resource depletion or pollution, waste management, stratospheric ozone depletion, changes in land use, ocean acidification and changes to the nitrogen and phosphorus cycles, whereas Social Issues relate to the rights, well-being and interests of the people and communities. These include: human rights, labour standards in the supply chain, child, slave and bonded labour, workplace health and safety, freedom of association and freedom of expression, human capital management and employee relations; diversity; relations with local communities, activities in conflict zones, health and access to medicine, HIV/AIDS, consumer protection; and controversial weapons and Governance Issues are the issues relating to the governance of companies and other investee entities such as board structure, size, diversity, skills and independence, executive pay, shareholder rights, stakeholder interaction, disclosure of information, business ethics, bribery and corruption, internal controls and risk management, and, in general, issues dealing with the relationship between a company's management, its board, its shareholders and its other stakeholders. Thus, ESG is the term which is the integration of two important concepts: Corporate Social Responsibility (CSR) and Corporate Governance (CG).

Conclusion and Future Scope of the Study

The corporate reporting of environmental, social and corporate governance factors has increased over the last few years (Peiro, Segarra, Mondejar and Vargas (2013). There are so many reasons to report on the material ESG issues by the corporations such as stakeholders' concern, government regulations and policies, international and national standards for sustainability etc. In fact, investment managers now prefer the disclosure of ESG indicators which indicates the long term performance of the. They integrated these indicators into their investment decision making (Kocmanova, Karpisek and Klimkova, 2012). Therefore the relevance of disclosing ESG factors in corporate reporting has increased among the corporate sector. More and more research on ESG in developing economies is emerging. It is required to understand the emergence of the concept of ESG. Examination of the two important terms CSR and CG and their integration into ESG could propagate flawed understanding of the concepts. The suggestions of future research include:

1. ESG reporting of organisations in developing economies. This research would examine the reporting of material ESG factors by organisations. The legislation framework in favour of the disclosure of key ESG factors in developing economies make corporations and other organisations to report on these non-monetary factors. Examination of these reporting practices may contribute the stakeholders of the organisaiton and also provide in depth knowledge of the applicability of these reporting practices in economies.

2. Relevance of ESG factors in investment decision making. Another research area is the materiality of ESG factors in investment decision making. By presenting the materiality of these factors, further studies may contribute in investment sector. As the investors and asset managers are integrating the ESG factors into their investment decision making. But every organisational sector has its own factor list and it may happen that one factor which is relevant for one sector may be irrelevant to another.

3. Perception of stakeholders towards ESG investing. The researchers may examine the perception of stakeholders towards ESG investing and reporting. To examine whether the stakeholders are aware about the relevant ESG factors or not. It is totally based on the marketing perspective. Stakeholders may include employees, customers, investors etc. This study may contribute the corporate sector for emphasizing the material ESG factors which are considered and preferred by stakeholders.

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