The effects of internal, external and aggregated CSR practices on the firm’s reputation and profitability

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Abstract

Purpose – Contemplating the concerns often expressed by skeptics about the value generated by corporate social responsibility (CSR) practices, this study aims to examine the effects of CSR practices on the firm’s reputation and profitability in the distinct socio-economic context of Nepal.

Design/methodology/approach – The study used a simple random sampling method in collecting data from 168 listed companies in Nepal. The data were collected using structured questionnaires. Then, hierarchical multiple regression analyses were used to test the stated hypotheses.

Findings – Results showed that all types of CSR practices positively affect the firm’s reputation and profitability. However, a firm’s reputation was better explained by the external CSR practices, and profitability was better explained by the internal CSR practices. Moreover, CSR practices were more strongly linked with the firm’s reputation than profitability.

Research limitations/implications – Perceptual data on profitability may be seen as a limitation although it can capture the current profitability situation as well as a future prospect within a single construct.

Practical implications – Practicing managers can consider CSR as an important strategic issue to stay ahead in competition rather than simply a response to regulatory requirements or stakeholder pressures.

Originality/value – Perhaps this is the first study to examine the effects of internal CSR practices, external CSR practices, and aggregated CSR practices separately on the firm’s reputation and profitability in the unique socio-economic context of Nepal.

Keywords Profitability, Corporate social responsibility, External CSR practices, Firm’s reputation, Internal CSR practices

Paper type Research paper

1. Introduction

Despite the lack of consensus on the specific meaning, the concept of corporate social responsibility (CSR) essentially revolves around the role of business in society. There is a
spectrum of viewpoints on CSR from pure profit-making approach to political roles of business in society. However, the stakeholder theory is probably the most widely held approach of CSR (Turker, 2009; Pedersen, 2015). Based on the premise of the stakeholder approach of CSR, recent literature has broadly classified firm’s CSR practices into two as internal CSR practices and external CSR practices (Brammer et al., 2007; Hameed et al., 2016; Hur et al., 2019). Many scholars have argued that fulfilling the prudent interests of internal and external stakeholders is not only a morally right thing to do but also strategically appropriate (Freeman, 1984; Porter and Kramer, 2006). Among others, responsible business practices can contribute to a firm’s reputation and profitability (Carroll and Shabana, 2010). However, this proposition is not yet fully established (Park and Lee, 2009; Kong et al., 2019). Studies have shown conflicting results across contexts.

Story et al. (2016) found that both internal and external CSR practices are positively related to the firm’s reputation as well as organizational attractiveness. Likewise, Esen (2013) found that CSR is helpful in improving reputation with a wide array of internal as well as external stakeholders. However, some scholars argue that building an image as a socially responsible firm may create certain expectations among stakeholders, which makes incongruent business behaviors more noticeable to activists and other stakeholders, and hence a firm may be exposed to reputational risk (King and McDonnell, 2012).

Significant efforts have been made to examine the effects of CSR practices on a firm’s profitability as well. Studies have shown positive relationship (Cherian et al., 2019; Wei et al., 2020), conditional positive relationship (Gherghina et al., 2015), negative relationship (Hirigoyen and Poulain-Rehm, 2015), neutral or insignificant positive relationship (Fogler and Nutt, 1975; Mwangi and Jerotich, 2013), inverted-U-shaped relationship (Barnett and Salomon, 2006), and mixed relationships (Schreck, 2011; Feng et al., 2017) between CSR practices and profitability and other measures of financial performance. Various meta-analyses have also revealed that the results may vary across contexts (Orlitzky et al., 2003; Vishwanathan et al., 2019).

However, there is a dearth of research studies examining the effects of CSR practices on a firm’s reputation and profitability by segregating CSR practices into internal CSR practices and external CSR practices, making the studies difficult to understand the implications of internal, external, and aggregated CSR practices separately. Moreover, some studies have simply used the proxies of internal CSR practices (such as cost of employee training and development) and external CSR practices (such as donations to charities or philanthropic activities) instead of considering the CSR practices toward the wide array of internal as well as external stakeholders (Habaragoda, 2018; Deng et al., 2019).

Against this backdrop, this study examines the effects of CSR practices on a firm’s reputation and profitability by taking separate measures of internal CSR practices, external CSR practices, and aggregated CSR practices in the Nepalese context. Hence, this research builds a case for the effects of internal, external, and aggregated CSR practices on a firm’s reputation and profitability in the context of a least developed country in the global south.

2. Review of literature and statement of hypotheses
2.1 CSR practices and the firm’s reputation
A firm’s reputation is a stakeholders’ perception of a firm’s ability to create value for stakeholders relative to its competitors (Jones, 2005). Many scholars have argued that CSR practices are the important antecedents of reputation (Wang, 2008; Zhu et al., 2013). According to Stephenson (2009), CSR practices can enhance a firm’s reputation by fulfilling the needs of different stakeholders and improving relationships with them. Overwhelming past research evidence also provides support to the notion of the positive effect of CSR
practices on a firm’s reputation (Stanaland et al., 2011; Taghian et al., 2015; Cherian et al., 2019).

Based on the above discussed conceptual foundation and empirical evidence on the relationship between CSR practices and the firm’s reputation, the following hypothesis is proposed:

\[ H1 \] A firm’s CSR practices positively affect its reputation.

2.2 CSR practices and profitability

Probably the most widely accepted role of business is to produce and sell goods and services for a profit. CSR practices without profit are always questionable (Carroll, 1991). Studies show that CSR practices are instrumental in securing employees’ commitment, satisfaction, and performance (Brammer et al., 2007; Story and Castanheira, 2019). Likewise, Pivato et al. (2008) found that customers’ perception of responsible business behavior is associated with their trust and loyalty toward a business, which ultimately leads to increased sales. Scholars argue that CSR practices are also instrumental to improve relationships with the community, government, and other stakeholders (Freeman, 1984; Porter and Kramer, 2006). CSR activities can increase productivity and decrease costs through waste reduction, saving of energy, and process improvement programs (Brown, 1998; Roberts and Dowling, 2002). Moreover, CSR practices can contribute to product, process, and business model innovations (Pedersen and Bjartmarz, 2015). Thus, it can be postulated that CSR practices trigger financial performance (including profitability) through non-financial performance routs like employee commitment and satisfaction, customer trust and loyalty, improved stakeholder relationships, cost reduction, and different innovations. A substantial number of past studies have also demonstrated a positive effect of CSR practices on a firm’s profitability (Mishra and Suar, 2010; Yusoff and Adamu, 2016; Wei et al., 2020). Thus, it is hypothesized that:

\[ H2 \] A firm’s CSR practices positively affect its profitability.

However, the literature suggests that additional variables, also known as control variables, often confound the relationships between independent and dependent variables (Bryman and Bell, 2011). Thus, they must be held constant or neutralized while examining the relationships between independent and dependent variables. Among others, the firm’s age and firm’s size are the widely accepted control variables that may confound the relationships between CSR practices and firm performance (Rettab et al., 2009; Saxena and Kohli, 2012; Javaid and Al-Malkawi, 2018). Thus, based on the above-stated hypotheses and the use of control variables in the model as practiced in past studies, a conceptual framework has been depicted as shown in Figure 1.

**Figure 1.** Conceptual framework for examining the effects of CSR practices on the firm’s reputation and profitability.
3. Methods

3.1 Population and sampling framework
The population of this study comprises firms listed in the Nepal Stock Exchange (NEPSE). A simple random sampling method was used to select sample firms from among the exhaustive list of listed companies. Out of 190 questionnaires sent to the selected companies, 168 duly filled-in questionnaires were obtained. The CEO or a senior-level manager from each selected company was requested to fill up the questionnaire since it was believed that senior level-managers could provide more accurate and candid information on CSR practices and firm performance than the lower-level people in the company.

3.2 Data collection instrument and procedure
Data on CSR practices, firm’s reputation, profitability and firm’s age were collected through structured questionnaires whereas the data on the firm’s size (measured in terms of total assets) was obtained through published annual reports. The data on CSR practices were perceptual in nature as it appears as a widely accepted approach to measure CSR practices (Mishra and Suar, 2010; Yusoff and Adamu, 2016), and since there are no independent CSR rating agencies in Nepal to produce objective information on CSR. Likewise, the data on the firm’s profitability was also perceptual in nature as practiced in some past studies (such as Rettab et al., 2009). This was done mainly because manager’s self-reported perceptual data can include multiple items within a single construct and it may capture current profitability situation as well as future prospect whereas accounting-based measures (such as ROA) are based only on the historical performance (Christensen et al., 2010) and market-based measures (such as Tobin’s Q) are mainly hinged on the future prospect (Rust et al., 2004).

The questionnaires were designed in English and pretested with managers and experts in the field. Then, the final version of the questionnaire was personally handed over to the identified respondents along with a cover letter stating the objective of the study and promise of confidentiality. Finally, follow-up calls were done as required and filled-in questionnaires were collected.

3.3 Variables used in the study
There are three sets of variables used in the study. Internal CSR practices, external CSR practices, and aggregated CSR practices were the independent variables in the study whereas the firm’s reputation and profitability were the dependent variables. The firm’s size and firm’s age were taken as control variables, which confound the relationships between CSR practices and the firm’s reputation as well as profitability. Table 1 provides the operational definition of variables used in the study.

3.4 Data analysis tools and techniques
First of all, the reliability of constructs was tested using Cronbach’s alpha coefficients, and they were found above the generally accepted level of 0.7 as suggested by Nunnally (1978). Then, the normality of data concerning various constructs was examined using the Shaprio–Wilk test since this test is generally recommended for samples up to 2000 (Garson, 2012). Data on all variables were found normal except for the firm’s size. Normality was achieved in the firm’s size after logarithmic transformation. Finally, the hypothesized relationships between independent and dependent variables were tested using hierarchical multiple regression analysis by controlling the confounding effects of the firm’s size and firm’s age.

While performing hierarchical multiple regression analysis, the assumptions of normality, linearity, and homoscedasticity were also tested by observing the values of
variance inflation factor (VIF) as well as the visual examination of normal P-P plots and scatter plots of the regression standardized residuals. The required assumptions were adequately met since all the VIF values were less than 10, all the data points in the normal P-P plots were in a reasonably straight diagonal line, and there was an absence of a clear or systematic pattern of residuals in the scatterplots.

4. Results
Table 2 shows descriptive statistics and Pearson correlation coefficients among variables under study. Significant positive correlations were found between the firm’s age and external CSR practices showing that older firms demonstrated a higher-level of external CSR practices.
practices. However, the firm’s size was positively associated with all types of CSR practices. Similarly, all types of CSR practices were positively correlated with the firm’s reputation and profitability. The descriptive statistics showed that though the internal CSR practices of Nepalese companies were above the moderate level, external CSR practices were only at a moderate level.

The correlation coefficients measure the bidirectional relations between variables that are unreserved in regression analysis (Mishra and Suar, 2010). Therefore, to examine the effects of different types of CSR practices on the firm’s reputation and profitability by controlling the confounding effects of the firm’s age and size, hierarchical multiple regression analyses were used.

Table 3 reports the results of hierarchical multiple regression analyses for the firm’s reputation. The results reveal that internal CSR practices ($\Delta R^2 = 0.319, p < 0.001$) external CSR practices ($\Delta R^2 = 0.322, p < 0.001$), and aggregated CSR practices ($\Delta R^2 = 0.402, p < 0.001$) affect firm’s reputation. Therefore, the results fully supported the first hypothesis of the study, that is, a firm’s CSR practices positively affect its reputation. Results also demonstrated that, among the two control variables, the influence of firm’s size was stronger ($\beta = 0.349, p < 0.001$) than the influence of firm’s age ($\beta = 0.171, p < 0.05$) on firm’s reputation.

Likewise, Table 4 portrays the results of hierarchical multiple regression analyses for the firm’s profitability. The results indicated that all types of CSR practices affect the profitability of firms and hence the data supported the second hypothesis as well. However, the results showed that the internal CSR practices, external CSR practices, and aggregated CSR practices – after controlling the confounding effects of control variables – predicted only 25%, 20.7% and 28.2% variances of profitability respectively. Thus, despite the achievement of statistical significance on both the cases, the effect of a firm’s CSR practices on its reputation was stronger than the effect of a firm’s CSR practices on its profitability.

| DV         | Step | IV                  | $B$  | SE $B$ | $\beta$ | $R^2$ | $\Delta R^2$ | $F$      |
|------------|------|---------------------|------|--------|---------|-------|---------------|----------|
| Reputation | 1    | Age                 | 0.016| 0.007  | 0.171   | 0.178 | 17.861        | ***      |
|            |      | Size                | 0.739| 0.153  | 0.349   |       |               | ***      |
| Reputation | 2    | Age                 | 0.013| 0.005  | 0.133   | 0.497 | 54.050        | ***      |
|            |      | Size                | 0.465| 0.123  | 0.220   |       |               | ***      |
| Reputation | 1    | Internal CSR practices | 0.016| 0.007  | 0.171   | 0.178 | 17.861        | ***      |
|            |      | Size                | 0.739| 0.153  | 0.349   |       |               | ***      |
| Reputation | 2    | Age                 | 0.007| 0.005  | 0.079   | 0.500 | 54.729        | ***      |
|            |      | Size                | 0.397| 0.125  | 0.187   |       |               | **       |
| Reputation | 1    | External CSR practices | 0.659| 0.064  | 0.603   | 0.500 | 75.360        | ***      |
|            |      | Size                | 0.739| 0.153  | 0.349   |       |               | ***      |
| Reputation | 2    | Age                 | 0.008| 0.005  | 0.086   | 0.580 | 75.360        | ***      |
|            |      | Size                | 0.349| 0.114  | 0.165   |       |               | **       |

**Table 3.** Hierarchical multiple regression analysis of CSR practices predicting the firm’s reputation

**Notes:** DV = dependent variable, IV = independent variable, $B$ = beta, SE $B$ = standard error of beta, $\beta$ = standardized beta, $R^2$ = coefficient of determination, $\Delta R^2$ = change in coefficient of determination, $F$ = $F$-test statistic. $N$ = 168; *$p < 0.05$; **$p < 0.01$; ***$p < 0.001$.
However, it is interesting to note that the firm’s age had no significant effect on the firm’s profitability ($\beta = 0.140$, $p > 0.05$) and the firm’s size had a lesser impact on profitability ($\beta = 0.172$, $p < 0.05$) unlike in the case of firm’s reputation.

5. Discussions
Several theoretical perspectives, particularly developed in the North American context, postulate that CSR pays off in terms of non-financial and financial performance (Freeman, 1984; Porter and Kramer, 2011). The results of this study have further strengthened this postulation in a different socio-economic context of Nepal by diagnosing the positive effects of CSR practices on the firm’s reputation and profitability. While the findings of this study corroborate with many studies (Sanchez et al., 2015; Story et al., 2016; Cherian et al., 2019; Wei et al., 2020), they also fully or partially contradict some other studies (Price and Sun, 2017; Taghian et al., 2015; Matuszak and Rozanska, 2019).

Sanchez et al. (2015) found a significant positive effect of CSR practices on a firm’s reputation in the Spanish context. Interestingly, Story et al. (2016) found that although both external and internal CSR practices affect a firm’s reputation, external CSR was a better predictor of a firm’s reputation than internal CSR. These findings are in line with the arguments that CSR practices act as reputation insurance (Minor and Morgan, 2011) and can enhance organizational attractiveness (Zhang et al., 2019). This is also congruent with the theory of “Red Queen Competition” (van Valen, 1973; Derfus et al., 2008), which implies that if a firm wants to evolve and be reputed it has to do something “different” or “extra” in line with stakeholders’ expectations beyond what it is currently doing.

Likewise, Cherian et al. (2019) found a positive relationship between CSR and a firm’s reputation as well as profitability. A recent study conducted in the context of the USA also found that CSR improves financial performance whereas corporate social irresponsibility reduces the firm’s financial performance (Wei et al., 2020). However, Taghian et al. (2015) demonstrated a positive relationship of CSR practices with reputation but not with profitability. In contrast to general expectations, Price and Sun (2017) found that firms with

| DV         | Step | IV               | B    | SEB  | $\beta$ | $R^2$ | $\Delta R^2$ | $F$  |
|------------|------|------------------|------|------|---------|-------|--------------|------|
| Profitability | 1    | Age              | 0.018| 0.010| 0.140   | 0.060 |              | 5.259**|
|             |      | Size             | 0.496| 0.224| 0.172*  |       |              |       |
|             | 2    | Age              | 0.014| 0.009| 0.106   | 0.310 | 0.250        | 24.577***|
|             |      | Size             | 0.166| 0.197| 0.057   |       |              |       |
|             |      | Internal CSR practices | 0.983| 0.128| 0.516***|       |              |       |
| Profitability | 1    | Age              | 0.018| 0.010| 0.140   | 0.060 |              | 0.140 |
|             |      | Size             | 0.496| 0.224| 0.172*  |       |              |       |
|             | 2    | Age              | 0.009| 0.009| 0.066   | 0.267 | 0.207        | 19.879***|
|             |      | Size             | 0.123| 0.206| 0.042   |       |              |       |
|             |      | External CSR practices | 0.720| 0.106| 0.483***|       |              |       |
| Profitability | 1    | Age              | 0.018| 0.010| 0.140   | 0.060 |              | 5.259**|
|             |      | Size             | 0.496| 0.224| 0.172*  |       |              |       |
|             | 2    | Age              | 0.009| 0.009| 0.068   | 0.342 | 0.282        | 28.451***|
|             |      | Size             | 0.050| 0.195| 0.017   |       |              |       |
|             |      | Aggregated CSR practices | 1.043| 0.124| 0.562***|       |              |       |

Notes: DV = dependent variable, IV = independent variable, B = beta, SEB = standard error of beta, $\beta$ = standardized beta, $R^2$ = coefficient of determination, $\Delta R^2$ = change in coefficient of determination, F = F-test statistic. $N = 168$; *$p < 0.05$; **$p < 0.01$; ***$p < 0.001$
low levels of CSR perform better than firms with high levels of CSR. Interestingly, Matuszak and Rozanska (2019) discovered a U-shaped relationship between internal CSR practices and profitability whereas an inverted-U-shaped relationship between external CSR practices and profitability.

Differences in findings between studies may be attributed to the diverse measures of CSR practices, differences in methodologies and statistical techniques used, and the dissimilarities in socio-economic as well as institutional contexts (Steiner and Steiner, 2016). For instance, some studies have used charitable contributions (Lev et al., 2010; Deng et al., 2019), some have used CSR indices or ratings (Waddock and Graves, 1997; Hirigoyen and Poulain-Rehm, 2015), some have used perceptual data on stakeholder-related aspects (Mishra and Suar, 2010; Sinha et al., 2018), and quite a few studies have used CSR scores based on content analysis of annual reports (Mwangi and Jerotich, 2013) to measure CSR practices.

The positive relationship between CSR practices and profitability identified in this study is congruent with the argument that responsible business behavior toward stakeholders is not only a morally right thing to do but also strategically appropriate to gain stakeholder support, enhance the firm’s reputation, and improve profitability (Freeman, 1984). However, the results showed that CSR practices better explained the firm’s reputation than its profitability. It may be attributed to the fact that responsible business practices generally trigger a favorable evaluation of stakeholders toward the firm, which in turn leads to an enhanced reputation. However, some CSR practices such as altruistic or philanthropic CSR, may not necessarily lead to tangible financial benefits at least in the short-run.

Likewise, internal CSR practices better explained the profitability whereas external CSR practices better explained the firm’s reputation. This may be ascribed to the fact that internal CSR practices may enhance employee commitments (Mory et al., 2015) and operational efficiency (Frank and Obloj, 2014), which eventually result in improved profitability (Yoon and Chung, 2018). But, external CSR practices have a direct and strong influence on a firm’s reputation whereas they generally have an indirect (and often lesser) impact on operational profitability (Lii and Lee, 2012). This is because it may take some time to realize financial benefits from the investments in customers, community, and environment-related activities (Yoon and Chung, 2018). While interpreting the results, it is also noteworthy to mention that several other firm-specific and macro-environmental control variables such as firm’s leverage, industry sector, market risk factors, and socio-economic conditions, which are beyond the scope of this study, may also confound the relationships between CSR practices and firm’s reputation as well as profitability.

6. Conclusion
The results of this study showed that CSR practices toward both the internal and external stakeholders pay off to business in terms of enhanced corporate reputation and profitability. Thus, this study has further strengthened the notion: “doing good does well” (Freeman, 1984; Porter and Kramer, 2006; Visser, 2010), and refuted the argument that “CSR and profit maximization are the conflicting goals of a firm”, often expressed by the skeptics such as Karnani (2011). These findings are quite important for encouraging the private sector’s genuine engagement in CSR practices in less developed countries like Nepal where governments have limited capacities and resources to fill governance gaps, and address the various pressing social needs.

Since the study has used only the perceptual measure of profitability, future studies may incorporate accounting-based measures and market-based measures of profitability for robustness check. Similarly, more control variables can be added to the model. Policymakers
can mandate companies for making sincere efforts on CSR issues without any confusion, and companies can also embrace CSR practices candidly as if they were a business.

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