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Corporate Governance and Corporate Social Responsibility of Indian Companies

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Executive Summary

This study aims to investigate the interaction between Corporate Governance and Corporate Social Responsibility (CSR) activities undertaken by Indian corporate. We find by reviewing the available literature that there is no single theoretical background which couples the CSR and the corporate governance at the firm level together and therefore to build a research framework, various theories from transaction cost economics and organization behaviour are needed to be explored.

Our study provides an extensive literature survey describing the interaction between CSR and corporate governance deriving from an academic literature as well as survey reports across the world. The interdisciplinary nature of our research framework that cuts across behaviour economics and management science to understand the interaction between CSR and corporate governance yields a comprehensive literature review which to best of our knowledge is missing. From the review of literature, we propose our empirical analysis to build on competing hypotheses as: (1) On the one hand, CSR can be thought of an extended model of "Corporate Governance" which implies inclusion of CSR into the check box of "Good" corporate governance practices that will complement the effect of good corporate governance. (2) On the other hand, the abuse of CSR may also result by just opening another way of expropriation of small investors by dominant promoters and large shareholders. This is an empirical question and provides implications for the two mechanisms that have profound impact on firm's objective function.

The empirical framework developed to investigate the impact of governance practices on corporate social responsibility accounts for the sample selection bias and measurement error which is pervasive in most of the existing studies on CSR and corporate governance. Apart from its contribution through a robust empirical framework to analyse the interaction between the corporate governance and CSR, data per se also adds a lot of value to our study. Unlike many studies which utilizes the secondary data provided by Karmayog, Forbes, CSR Identity, etc. we have meticulously hand-picked the data by carefully scrutinizing the publicly available information for each of the companies in our sample. This process has yielded a unique 3-year panel data for large 500 firms with detailed information on CSR activities across all the possible avenues. We believe that this unique dataset can be utilized further to support other future researches on CSR. We predict CSR score for every company in our sample using the distribution obtained from our empirical model which is further validated across different categories of CSR spending—no CSR, low CSR, medium CSR and high CSR. We propose that this score can be used as an important tool to predict the probability of a firm being classified in a particular range of CSR. We also validate this scoring methodology for a random set of companies selected out of our existing sample. This ensures the applicability of our methodology to predict the likelihood of undertaking CSR activity by a firm which can be used by policy makers as well as researchers in future.

Our first estimation methodology controls for the sample selection as in absence of regulatory compliance, many of the firms do not report amount spent on CSR and report disclosure of CSR activities instead.

We find that firms which are older, larger and pay dividend are more likely to undertake the CSR activities. We also find significant positive relationship between CSR and proportion of controlling shareholders which implies that founding families or government are driven by strategic decision of investing into CSR-related activities. This is also in line with the positive relationship between insiders' control over board and CSR. In contrast, fraction of independent directors does not affect the CSR even though our univariate analysis suggests that firms with higher proportion of independent directors spend more on CSR activities.

To our surprise, profitability does not have any significant relationship with CSR activities. This questions the recent mandate of diverting 2 % of the profit towards CSR activities in the Companies Act 2013. It is worth noting that some of the puzzling results presented in this section could be due to the unobservable nature of our attributes such as corporate governance along with the inaccurate measurement of the proxies to capture these attributes. We attempt to address some of these challenges in the following chapter by developing a structural equation model.

Further, the results are robust to the out of sample validation. We also develop a robust methodology to predict the propensity of CSR activities that are likely to be undertaken by the firms based on four categories—no, low, medium and high CSR—respectively. This method is tested and validated for a random sample of 50 companies that are not part of our sample.

We further present the structural equation model that address two critical issues related to the unobservability of the attributes derived from various theoretical constructs and potential measurement errors. Further the proposed model also incorporates the possibility of cross-correlations across the unobservable factors. The results show that all the four specified attributes—structure, financial constraint, corporate governance and duality—significantly influence the CSR spending of large Indian firms. More specifically, we find evidence that poor corporate governance coupled with insider control over the board tend to explain the variation in CSR activities across firms. The other conventional factors such as age, size and financial viability of a firm also contribute to the CSR spending by these firms.

Finally, we test whether firms by engaging into socially responsible activities gain (or lose) returns in excess of the market in the structural equation framework that we develop to account for unobservability of the attributes and measurement errors. We find that market does not differentiate whether the firm undertakes CSR activities. In addition, the financial constraint attribute of the firm significantly and positively affects the excess returns, while poor corporate governance does not impact on the excess returns. This finding implies that the conventional factors such as dividend payout, profitability and leverage matter more to the investors. This in turn supports the stakeholder approach rather than the shareholder value maximization approach of analysing CSR.