ASIAN ACADEMY *of*
MANAGEMENT JOURNAL
of ACCOUNTING
and FINANCE

AAMJAF, Vol. 3, No. 1, 21–36, 2007

DOES IT PAY TO BE GOOD IN DEVELOPING COUNTRIES? THE RELATIONSHIP BETWEEN CSR AND FINANCIAL PERFORMANCE IN MALAYSIA

Bala Ramasamy[1*], Hung Woan Ting[2] and Matthew C.Y. Yeung[3]

[1]*China Europe International Business School, Shanghai,*
699 Hong Feng Road, Pudong, Shanghai, P.R. China
[2]*Nottingham University Business School, Malaysia Campus*
Jalan Broga, Semenyih, Selangor, Malaysia
[3]*School of Business, The Open University of Hong Kong,*
30 Good Shepherd Street, Homantin, Kowloon, Hong Kong

*Corresponding author: bramasamy@ceibs.edu

ABSTRACT

Corporate social responsibility (CSR) as a common business practice has only recently established a foothold in developing countries. This is evidenced by a lack of literature in the area of CSR among these countries. In Malaysia, for instance, only a third of large businesses can be considered CSR active. The purpose of this paper is to determine if there is a link between CSR performance and financial performance among these large businesses. We compare the monthly average returns of a portfolio of CSR active companies (based on disclosure) against a portfolio of inactive CSR companies as well as against the market, represented by the Kuala Lumpur Stock Exchange Composite Index (KLSE-CI). Both risk unadjusted and risk adjusted returns were utilized in this study. In either case, we do not find strong statistical evidence to show that our CSR portfolio outperforms the market; neither does it beat the non-CSR portfolio. Nevertheless, based on the results obtained by similar studies in the US, UK and Australia, there is reason to believe that CSR active companies may outperform their counterparts when consumers, employees and other stakeholders increase the value they place on socially responsible activities of a firm. Our findings also imply that international investors looking for socially responsible companies in developing companies to invest in need not incur significant opportunity costs when carrying out their investment strategies. Given that developing countries like Malaysia feature strongly in international investment portfolios like the Morgan Stanley International Composite Index (MSCI), socially responsible investors could extend their portfolios internationally without compromising their rate of returns.

Keywords:

INTRODUCTION

From Moskowitz (1972) to Johnson (2003), spanning more than three decades, the benefits of being a socially responsible investor have been questioned repeatedly. The answers, however, are inconclusive. One view is that being socially responsible adds costs to the organization which reduces the level of profits (for example, Aupperle, Carroll, & Halfield, 1985; Ullmann, 1985). The opposite view is that corporate social responsibility (CSR) and financial performance is positively correlated because socially responsible firms will have employees with high morale and customers who may be more loyal (for example, McGuire, Sundgren, & Schmeeweis, 1988; Soloman & Hansen, 1985; Hillman & Keim, 2001; Carden & Darragh, 2004). This paper joins the debate but with a distinct feature. Previous attempts at unraveling the link between CSR and financial performance have focused primarily on industrialized nations like the US, UK and Australia. The increasing awareness of CSR among developing countries motivates us to solicit an answer to this old question but in a new environment: are the returns from investing in socially responsible firms in developing countries sufficiently attractive to investors?

This paper considers this question by evaluating the stock performance of CSR active companies against its counterparts which are not active as well as against the stock market as a whole. In this regard, we assume that changes in stock prices represent a reliable measure of financial performance in that a firm that portrays such performance would see the demand for its stocks increasing resulting in higher prices, and vice versa. This is sufficiently explained by the efficient market hypothesis.

We have chosen Malaysia as our focus as it represents a typical developing country which has undergone substantial structural changes in recent decades. Malaysia is a small open economy in Southeast Asia with a per capita income of about USD3,540 (www.worldbank.org) and has been categorized in the upper middle-income level by the World Bank. The economy was battered during the Asian financial crisis in 1997 but through bold policies (Zainal Abidin, 2000; Ramasamy & Yeung, 2002), it has been able to revive its economy such that it experienced nearly 5.2% growth in 2003 (www.statistics.gov.my).

Previous research on CSR in Malaysia is not yet extensive. Teoh and Thong (1984) pointed out that the philosophy of the top management and legislation were the primary factors contributing to corporate social awareness in Malaysia. More recently, Malaysian executives and managers were found to have positive attitudes towards CSR, although the extent of their involvement in CSR is lower today than it was a decade ago (Abdul Rashid & Ibrahim, 2002). Mohammad Jamil, Alwi, and Mohamed (2001) similarly found that CSR disclosure in Malaysia is generally low, especially with regards to fair business information. This also appears true for environmental information (ACCA, 2002). The level of CSR was again confirmed to be low in recent studies conducted by SRI (2003) and Ramasamy and Hung (2004).

Nevertheless, Malaysia has demonstrated an increasing awareness of CSR in recent years. The emergence of non-governmental organizations (NGOs) such as the Consumer Association of Penang (CAP), the Federation of Malaysia Consumers Association (FOMCA) and the UN Global Compact in Malaysia has contributed towards this awareness. While there is yet to be any statutory requirement in Malaysia for public-listed companies (PLCs) to disclose information relating to their CSR activity, the launch of a CSR Framework by Bursa Malaysia in September 2006 provides useful guidance for Malaysian PLCs to help them implement reporting on CSR. This initiative has definitely added a valuable dimension to the revised listing requirements of the Kuala Lumpur Stock Exchange (KLSE) that require disclosure of information that has the potential to influence the financial performance of a company. The issuance of the Malaysian Code on Corporate Governance in March 2000 also sent a clear and strong message about the importance and urgency of being an accountable and responsible corporate entity. The Malaysian Accounting Standards Board (MASB) has also incorporated a new standard that makes explicit reference to environmental reports and value-added statements in encouraging companies to present additional information if management believes they will assist users in making economic decisions (ACCA, 2003).

LITERATURE REVIEW

Milton Friedman's (1970) article in the *New York Times Magazine* claimed that the purpose of a business is to make profits and that any improvement of welfare to society should be best left to the government. If businesses were to get involved in any socially responsible activities, it should be due to some gain that could be accrued as a result of it. Friedman's article opened the doors to a great deal of research that looked at the link between social responsibility and financial performance. In an extensive review of past literature, Griffin and Mahon (1997) evaluated 51 articles that considered this relationship. Apart from the results, these studies also differed in terms of proxies used to represent CSR and financial performance as well as the extent of coverage, i.e. single or multiple industries.

There are two main methods of quantifying CSR among companies. The first approach uses some form of reputation indices based on an arbitrary rating provided by an organization of a group of knowledgeable people. These include ratings provided by the Council of Economic Priorities based on the pollution control performance among paper and pulp produces (Spicer, 1978), the national Association of Concerned Business Students (Moskowitz, 1972; Vance, 1975); the Domini 400 Social Index (Sauer, 1997), the CSR ratings by the New Consumer Group (Balabanis, Philips, & Lyall, 1998) and the Fortune annual survey of corporate reputation (McGuire et al., 1988). The second approach uses content analysis of corporate annual reports or other corporate documents to measure CSR. This approach assumes social reporting as representative of social actions. Among the studies that have used this approach include Abbott and Monsen (1979), Anderson and Frankel (1980) and Preston (1978). Both approaches suffer from biases. The former is dependent on the knowledge of the individuals or organizations while the latter approach favours larger corporations that are able to articulate their CSR activities.

Two main measures of financial performance have been utilized by previous studies. Balabanis et al. (1998), Spicer (1978), and Cochran and Wood (1984), for example, used accounting based performance. Common accounting measures used include earnings per share (EPS) and price/earnings ratio (P/E). The other common measure of financial performance is based on investor returns or stock market based returns. These studies (for example, Carden & Darragh, 2004; Sauer, 1997) employ changes in stock market prices and dividend returns as proxy. Both approaches have their merits and so several studies have utilized both measures (McGuire et al., 1988).

Most previous studies consider companies across industries (for example, Balabanis et al., 1998; Carden & Darragh, 2004; Cochran & Wood, 1984). Griffin and Mahon (1997) criticize a multi-industry analysis, pointing to the fact that different industries may show different levels of CSR and financial performance based on its particular internal and external pressures. The oil and gas industry, for example, is high profile when compared to the nuts and bolt industry. The pressures imposed on the oil and gas industry by pressure groups like Greenpeace or Friends of the Earth make sensational stories for the media. Still, there are a few industries that have focused on single industry analysis. These include Griffin and Mahon (1997) and Rockness, Schlachter and Rockness (1986), both on the chemical industry. However, the number of firms in one particular industry may inhibit the extent of empirical work for a single industry analysis.

Ullman (1985) and Griffin and Mahon (1997) provide an excellent review of the results obtained by older studies evaluating the CSR – financial performance link. We will focus on the results obtained by more recent studies. Similar to earlier researchers, more recent studies tend to provide more support for a positive relationship between CSR and financial performance. Carden and Darragh (2004) for instance, report returns of 8%–14% for socially responsible investing which they consider to be comparable to market returns. Sauer (1997) proves that investing in CSR active firms does not have an adverse effect on investment performance. Mallin, Saadouni, and Briston (1995) were able to prove that ethical funds in the US are able to beat the performance of non-ethical funds although they are unable to beat market performance. They claim that this is due to the increasing demand for ethical and socially responsible investments by a more knowledgeable investing public. Employing 103 mutual funds from Germany, UK and US, Bauer, Kees, and Otten (2002) claim that there is no significant difference between the risk-adjusted returns of socially screened funds and those that were unscreened. In Australia, however, Tippet (2001) concluded that investing in ethical funds does not pay.

An interesting feature among recent studies is the caveat that has been attached to a positive relationship between the two variables. Balabanis et al. (1998) for example, showed that only when CSR performance is disclosed widely does it have a positive effect on financial performance. Shaker, Oviatt, and Minyard (1993) and Hillman and Keim (2001) found that CSR is positively related to shareholder value if activities are concerned with stakeholders who are directly related to the organization (for instance, employees and customers), as opposed to mere participation in social issues like community development or the environment. Finally, Goll and Rasheed (2002) concluded that a positive relationship is dependent on the business environment in which the firm is operating. If the environment is one that is supportive and dynamic (referred to as "munificent"), socially responsible activities have a direct effect on firm performance. On the other hand, when the environment is hostile (reflected by scarce resources, cut-throat competition, etc.), firms are more likely to conserve and less likely to engage in CSR.

What has been observed from our literature review of the CSR-financial performance relationship is an obvious lack of studies considering this relationship among developing countries. Although the Social Investment Forum (2003) reports that there has been an increase in the size of socially responsible funds in Asia, whether such investments provide acceptable rate of returns is not discussed. Hence, this study may be the first to deal with this issue among developing countries.

DATA AND METHODOLOGY

Our sample comprised 100 companies that are included in the Kuala Lumpur Stock Exchange Composite Index (KLSE-CI) as at December 4, 2002. With more than 800 companies listed on the Kuala Lumpur bourse at the time of this study, our sample makes up 12% of the total. Despite the small sample, it is generally accepted that the component companies of the KLSE-CI is a useful performance indicator of the Malaysian stock market and reflects the development and changes that take place in the national business environment. Among the 100 companies, we had to exclude companies that were newly listed as well as those that did not publish their annual reports online. This reduced our sample size to 90.

Recognizing that CSR initiatives can take different perspectives including the firm's commitment to product quality and environmental management, its efforts to provide a safe and conducive working environment, and its contribution to community welfare, we referred to four main CSR themes, i.e. product/services, natural environment, employees, and community to determine disclosures made by the sample companies that relate to CSR. We perused the annual reports published by the sample companies for financial year-end between July 1, 2001 and June 30, 2002. We opted for the disclosure approach to gauge the extent of CSR among Malaysian companies. The choice was based on (1) non-availability of reputation index of Malaysian firms (or for that matter any developing country firms) and (2) the extent of disclosure can be taken as some indication of the importance of an issue to the reporting entity (Krippendorf, 1980). Furthermore, there are evidence that shows positive correlation between the emphasis of CSR in annual reports and reputation ratings (Bowman & Haire, 1975). The disclosure method used in this paper is measured by the number of words that a company uses to describe socially responsible activities in the narrative sections in the annual report. These exclude disclosures mandated by the local authorities, but include detailed discretional information relating to products and customers, environmental impact, community services and employees. In our sample, the CSR continuum ranges from a maximum of 4,614 words and a minimum of 0. The sample mean is 770, with a standard deviation of 979. See Table 1 for the distribution of disclosure.

The CSR disclosure levels were then used to categorize companies into two portfolios: "CSR companies" and "non-CSR companies". In achieving this, companies were first grouped by their business sector. Then, within each sector, we identified company with the highest level of disclosure and attempted to pair it up with company that has the lowest level of disclosure. Pairing is complete if both the companies are similar in size (as measured by market capitalization). If the sizes are not comparable by observation, we then proceed to pair up the next best available choices at both ends. The pairing exercise was necessary to ensure that the portfolio was as similar as possible and hence can be compared. The segregation based on the above procedures resulted in two portfolios consisting of 16 companies each. As in the case of Mallin et al. (1995: 484), we hope that the matching of companies "would eliminate the effects of special characteristics" like the small companies effect and sectoral risks. Table 2 shows the two portfolios that resulted from our matching procedure. Notice the marked difference in the averages of CSR disclosure of 1997 words for the CSR portfolio compared 126 words for the non-CSR portfolio. The market capitalization is, however, fairly similar (r = 0.88).

Table 1
Distribution of Corporate Social Disclosure

Disclosure level (words)	No. of companies	%
0	11	12
1–499	41	46
500–999	13	14
1000–1499	8	9
> 1500	17	19
	90	100
< 770	61	68
= 770	1	0
> 770	28	32
	90	100

We have used stock market-based performance indicators to measure financial performance. While we recognize the inherent limitations of using market-based indicators to depict company performance, we also realize the problems of using accounting measures that may suffer from managerial manipulation and differences in accounting procedures (McGuire et al., 1988). Further, since the length of the study covers only four years, stock price movements were chosen to represent financial performance (Ullmann, 1985). To obtain the portfolio returns, we weighted the monthly returns including dividends by the proportion of the portfolio market capitalization. The returns of the portfolios were compared against each other as well as against the performance of the market, i.e. the KLSE-CI.

To evaluate the performance of a portfolio by simply testing the arithmetic difference between the average return of the portfolios or with the average return of a benchmark counterpart draws a known pitfall. Investors buy and hold a high-risk stock or portfolio only if its returns can be compensated for the risk. The simple average return does not account for such risks that most sophisticated investors are averse to. Neither does it include any information about the relative performance given the market conditions. Thus, literature in the area of investment management recommends the evaluation of a portfolio on the basis of both the return and risk attributes (for example, Mallin et al., 1995; Tippet, 2001). Three widely used risk adjusted return measures proposed in the performance evaluation literature are employed in this study, i.e. the Sharpe, Treynor and Jenson indexes.

The Sharpe measure uses the capital market line as the benchmark. It is computed as $(r_p - r_f)/\sigma_p$, where r_p denotes the portfolio return, r_f denotes the risk free return and σ_p the standard deviation of the portfolio return over the investment horizon. The Treynor measure of risk-adjusted return uses the security market line as a benchmark. The computation is similar to Sharpe's but Treynor replaces the total risk by systematic risk. Thus, the Treynor's ratio measures return per unit of systematic risks and is calculated as $(r_p - r_f)/\beta_p$ where β_p is the systematic risk of the portfolio. β_p is obtained by regressing the portfolio return on the market index. Jensen's alpha (α_p) which measures risk-adjusted excess return, is the intercept in the regression $r_p - r_f = \alpha_p + \beta_p(r_m - r_f)$, where r_m is the average return on the market portfolio. For this study, the monthly rate of return on the KLSE-CI was used as a proxy for the return on the market portfolio while the yield from the three month Malaysian Treasury Bills represents risk free returns.

The time period of our analysis spans 48 months beginning January 2000 to December 2003. This was to ensure that the period was not too distant from the disclosure period, but at the same time far enough from the crisis effects of 1997.

RESULTS OF ANALYSIS

Since there have been no previous research that has considered whether investing in CSR active companies is worthwhile or otherwise, we were unable to assess a priori the possible outcome of our analysis. On the one hand, we could argue that the demand for CSR by investors, consumers, employees and other stakeholders in a developing country like Malaysia is at an initial stage. Under such circumstances, CSR activities only add costs to the firm without any guarantee of immediate returns. This implies that CSR firms would underperform when compared to non CSR firms or the market average. On the other hand, it is also possible that firms that are actively engaging in CSR are firms that are already financially successful. These firms utilize their excess funds in the service of their stakeholders. The involvement in CSR adds to the loyalty from stakeholders which further improve business performance. This would indicate that CSR firms would be outperforming both the non-CSR and perhaps even the market average returns.

Given the possible scenarios above, the research hypotheses to be tested would be as follows:

(i) The CSR portfolio performs differently (outperform or underperform) from the market.

(ii) The performance of the CSR portfolio is different to that of the non-CSR portfolio.

The results of our analysis are shown in Tables 3 to 6. In Table 3, the monthly raw rates of returns of the two portfolios, as well the benchmarked market is presented. Although the CSR portfolio performs better than the market in all the holding period under consideration (i.e. annually as well as the four-year period) except for the year 2000, statistical evidence does not confirm this observation. Comparing between non-CSR and the CSR portfolio, casual observation shows the former beats the latter in all years except 2001 and 2002. Again, our two-tailed t-tests do not support this observation. It should be noted that equal variances were assumed on all statistical tests, as indicated by insignificant Levene's test statistics for equality of variances.

Table 3
CSR Investment Strategy Comparison of Weighted Returns 2000–2003

Year	CSR (%)	NCSR (%)	Market index (%)	T-test comparison of means (CSR versus NCSR)	T-test comparison of means (CSR versus market)
2000	–1.253	0.052	–1.247	–0.441	–0.002
2001	1.791	1.443	0.460	0.139	0.492
2002	1.953	1.794	–0.499	0.056	1.006
2003	2.360	2.608	1.816	–0.117	0.274
2000–2003	1.213	1.474	0.133	–0.202	0.852

Table 4 presents the Sharpe index results. Our results show that the CSR portfolio performs better than the market index in all holding periods and mirrors our earlier unadjusted returns results when compared against the non-CSR portfolio. However, in this regard too, the two-tailed t-tests do not show significant difference between the returns. Table 5 shows the results when the Treynor index is used. The CSR portfolio performs better than the market index in all period holdings except for the year 2000. When compared with the non-CSR portfolio, the performance is mixed. The CSR portfolio performs better only in 2001 and 2002. There is, however, no statistically significant difference in the returns.

Table 4
CSR Investment Strategy Comparison of Sharpe Index Measures 2000–2003

Year	CSR (%)	NCSR (%)	Market index (%)	T-test comparison of means (CSR versus NCSR)	T-test comparison of means (CSR versus market)
2000	–0.221	–0.054	–0.235	–0.381	0.032
2001	0.387	0.273	0.110	0.275	0.669
2002	0.266	0.236	–0.128	0.073	0.969
2003	0.460	0.520	0.426	–0.143	0.079
2000–2003	0.223	0.244	0.043	–0.100	0.851

Table 5
CSR Investment Strategy Comparison of Treynor Index Measures 2000–2003

Year	CSR (%)	NCSR (%)	Market index (%)	T-test comparison of means (CSR versus NCSR)	T-test comparison of means (CSR versus market)
2000	–1.703	–0.422	–1.670	–0.375	–0.010
2001	3.072	2.285	0.829	0.233	0.701
2002	1.599	1.306	–0.641	0.123	0.993
2003	2.098	2.505	1.885	–0.206	0.112
2000–2003	1.266	1.419	0.101	–0.108	0.856

The difference between the Sharpe and the Treynor measures are related to the kind of risks measured. The Sharpe index considers the total risks in its risk adjusted computations. The Treynor index, on the other hand, measures only market risks and hence does not consider company specific risks (Preece & Filbeck, 1999). Thus, using the Sharpe index, the CSR portfolio utilized is well diversified such that it is able to beat the market returns in all periods under consideration. The Treynor measure seems to be similar to the raw unadjusted returns since our portfolio comprised of companies from different sectors and different sizes. That the Treynor measures are similar to the unadjusted measure confirms that there is no significant difference between the mean returns of the CSR portfolio and the market or even when compared to the non-CSR portfolio.

Results using Jensen's alpha does provide some indication that our CSR portfolio is able to beat the market performance, backed with statistical justifications. Like the Treynor measure, Jensen's alpha considers only systematic risks. A significant positive alpha indicates that the chosen portfolio has outperformed the market, and vice versa (Fabozzi, 2002). Our calculations in Table 6 show that, when the market index is used as the benchmark, the CSR portfolio does have an alpha which is positive and significant for 2001 and 2002, as well as for the entire 4-year period. There is no statistical evidence which shows that the CSR portfolio outperforms the non-CSR portfolio.

Table 6
CSR Investment Strategy Comparison of Jensen Alpha Measures 2000–2003

Year	α_1 (NCSR as the benchmark)	T-test H_o: $\alpha_1 = 0$	α_2 (Market index as the benchmark)	T-test H_o: $\alpha_2 = 0$	α_1 (NCSR as the benchmark)
2000	–1.288	–1.350	–0.003	–0.003	–1.288
2001	0.727	1.003	1.564	2.672*	0.727
2002	0.430	0.384	2.570	2.269*	0.430
2003	–0.046	–0.057	0.274	0.635	–0.046
2000–2003	–0.145	–0.326	1.085	2.525*	–0.145

Note: * significant at 5% level

CONCLUSION

CSR as a common business practice has only recently established a foothold in developing countries. The vacuum in the literature which considers the relationship between CSR initiatives and financial performance among developing countries is clear evidence that CSR activities among companies in developing countries is at an infant stage. Among large firms in Malaysia for instance, only about one third can be considered to be CSR active. More than one tenth of the component companies in the KLSE-CI do not even disclose any CSR related activities. However, given that disclosures are not required by law in Malaysia, and nearly two fifth of companies reporting relatively a high state of CSR provide further evidence that CSR is indeed on an increasing trend.

The purpose of this paper was to determine if there is a link between CSR performance and financial performance. Recent studies among firms in developed countries in this area show a positive relationship. This is not as readily observable in Malaysia. We compared the monthly average returns of a portfolio of CSR active companies (based on disclosure) against a portfolio of inactive CSR companies as well as against the market, represented by the CI. Both risk unadjusted and risk adjusted returns were utilized in this study. In either case, we do not find strong statistical evidence to show that our CSR portfolio outperforms the market; neither does it beat the non-CSR portfolio. Based on these results we will need to accept both null hypotheses. However, to write-off the link between these two variables may also be erroneous. Using the Jensen's alpha, we do find some evidence to show that the CSR portfolio beats the market in 2001 and 2002 as well as for the holding period of 2000–2003.

Considering the results of our analysis, we may conclude that there is little support to show that companies with strong CSR disclosure perform better than the market or those companies with weaker CSR disclosure. McWilliams and Siegel (2001) considered the amount of resources that a firm should allocate to CSR. Using a demand-supply model, they imply that a firm would allocate that amount of resources that would equate the additional revenue gained from engaging in CSR and the amount of additional costs incurred as a result of it. The additional revenue gained from CSR activities would depend on the extent to which consumers' demand CSR qualities in goods and services. For the Asian countries, most consumers are sensitive to price (Chou & Chen, 2004). In a survey of consumer purchasing behavior in Malaysia, Ahmed (2003) found that 85% of respondents considered price and quality of products as their most important influencing factor. Only 3% considered CSR activities of the firm as an important factor in their buying decisions. This may imply that Malaysian consumers may not value CSR and are not willing to pay a premium or even pledge loyalty to a product or service because of the CSR nature of the company. In other words, the marginal revenue of being CSR active may not be substantial. Whether or not a firm is increasing profits by being CSR active will then depend on the marginal costs of CSR activities, in terms of both added costs and reduced profitability for shareholders. Our results show that the increase in profits among CSR active firms are not substantial enough to distinguish them from those that do not or weak in CSR.

Nevertheless, based on the results obtained by similar studies in the US, UK and Australia, there is reason to believe that CSR active companies may outperform when consumers, employees and other stakeholders increase the value they place on socially responsible activities of a firm. Future research with larger sample size is definitely valuable to evident such expectation.

For the main question posed in this paper, i.e. whether it pays to be good among developing countries, our analysis on Malaysia shows that it does not. However, we must also note that there is no significant drawback in investing in these CSR active companies either. For the international investor who is looking for socially responsible companies in developing companies to invest in, our findings suggest that they need not incur significant opportunity costs when carrying out their investment strategies. Given that developing countries like Malaysia feature strongly in international investment portfolios like the Morgan Stanley International Composite Index (MSCI), socially responsible investors could extend their portfolios internationally without compromising their rate of returns.

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