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## Corporate Social Responsibility and Financial Performance: Role of Financial Distress

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## Corporate Social Responsibility and Financial Performance: Role of Financial Distress

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**Abstract:** This study explores the impact of corporate social responsibility (CSR) and financial distress on the financial performance of companies in Pakistan's PSX 100 Index. With a focus on societal contributions and competitive advantage, the research addresses the limited CSR activities in Pakistan, emphasizing the necessity for comprehensive policies promoting social welfare and economic growth. Analyzing data from 48 companies of manufacturing and financial sectors, the study uncovers insights into Pakistani industries, emphasizing the effects of CSR on financial performance in the presence of financial distress. It underscores the importance of balancing financial risks with social responsibilities, contributing to the understanding of CSR practices in developing countries and providing valuable guidance for businesses seeking to navigate these dynamics.

**Keywords:** Corporate social responsibility, financial performance, financial distress, return on assets, return on equity, net profit margin, earnings per share.

### Introduction

Corporate Social Responsibility (CSR) has evolved as a widely acknowledged business requirement, particularly within the service sector (Glavas & Kelley, 2014). With the help of this, companies as socially conscious organizations can distinguish themselves in a competitive market. Unlike conventional firms focused solely on profit, embracing CSR aligns with a stakeholder-oriented vision of an organization. However, in countries like Pakistan, the adoption of CSR practices still lags behind (Ramzan, Amin, & Abbas, 2021). Successful execution of CSR demands an understanding of industry-specific factors and the societal context in which organizations operate, a critical consideration in emerging economies where CSR strives to balance economic growth and societal welfare. Hence, the investigation between the relationship of CSR and financial performance is imperative for businesses operating in Pakistan, where limited research exists on this crucial relationship.

In developed nations, firms recognize CSR's importance in contributing not only to the economy but also to workplace practices, education, and customer relationships (M. A. Khan,

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Ahmad, & Fatima, 2021). By disclosing CSR information, companies aim to gather financial and nonfinancial benefits, including enhanced financial performance. However, in Pakistan, many companies lack a formal CSR policy, and attention to CSR activities is limited, particularly in sectors like health and education (S. Khan, Khan, Safiullah, Baloch, et al., 2021). The underdeveloped corporate governance landscape in Pakistan further impedes CSR implementation. Addressing this challenge requires the awareness of CSR at the academic level, with government support crucial for promoting CSR activities (Memon et al., 2014). While existing literature suggests a positive correlation between CSR and financial performance, empirical studies within the Pakistani context are scarce (Ikram et al., 2019). This study seeks to empirically examine the impact of CSR on financial performance in presence of financial distress, filling this research void and offering insights for both academia and practitioners. The findings aim to advance our understanding of CSR's role in enhancing financial performance and managing financial risks in the Pakistani business landscape.

The presence of financial distress poses formidable challenges for companies, influencing their financial performance and overall sustainability. Pakistan has grappled with various economic and political uncertainties, compounded by the impact of the COVID-19 pandemic, which exacerbates financial distress. Against this backdrop, understanding the relationship between CSR, financial performance, and financial distress becomes paramount. Existing literature suggests that CSR can contribute to a company's bottom line by integrating environmental and social concerns, enhancing resilience and stability (Wang, Sewon, & Claiborne, 2008). Yet, the link between CSR, financial performance, and financial distress necessitates further exploration, especially in emerging markets like Pakistan. This study endeavors to investigate this relationship by scrutinizing the moderating effects of financial distress on the impact of CSR on financial performance, providing valuable insights for managers to navigate financial risks and fulfill their social responsibilities (Ramzan et al., 2021). The findings seek to enrich the existing literature on CSR, financial performance, and financial distress, offering practical implications for firms navigating the challenges of Pakistan's business environment.

Between 2017 and 2022, Pakistan experienced heightened financial distress, exacerbated by political instability, domestic challenges, and the COVID-19 pandemic. Political uncertainties reduced investor confidence, constrained corporate resources, increased uncertainty and opportunities, and created a financially risky environment. Domestic issues such as infrastructure limitations, economic disparities, and corporate governance inefficiencies hindered business operations, impeding growth prospects and limiting effective resource allocation. The COVID-19 pandemic, with its associated lockdowns, lower consumer demand, supply chain disruptions, and economic slowdown, further strained incomes, increased spending, and led to a lack of liquidity. In this context, it becomes imperative for companies in Pakistan to comprehend the impact of financial distress on the intricate relationship between CSR and financial performance.

## CSR Landscape in Pakistan

The Corporate Social Responsibility (CSR) scenario in Pakistan has been examined by various scholars, shedding light on key aspects of its implementation. Shah and Khan (2018) investigation revealed a positive correlation between CSR initiatives and consumer behavior in Pakistan. Their findings suggest that companies should prioritize CSR endeavors as a means to not only attract but also retain customers in the Pakistani market. Shah and Raza (2017) identified barriers in the successful implementation of CSR, citing issues such as lack of awareness, insufficient resources, and inadequate government support. Their research accentuates the imperative of heightened government involvement and increased resource allocation by companies. The emphasis is on overcoming challenges to ensure effective CSR implementation in the Pakistani business landscape.

## Theoretical Foundation and Empirical Reviews

Stakeholder theory is pivotal in shaping corporate actions by emphasizing a company's responsibilities to a diverse range of stakeholders. These stakeholders include shareholders, employees, customers, suppliers, the community, and the environment. In contrast, Corporate Social Responsibility (CSR) involves voluntary initiatives taken by companies to address societal and environmental concerns that surpass legal obligations. CSR becomes a mechanism through which companies fulfill their commitments to stakeholders, involving activities such as charitable donations, environmental sustainability, and fair labor practices. Freeman (2010) advocates for a company's responsibility towards all stakeholders, urging the integration of CSR into overall strategic management. Additionally, Carroll (1991) presents the Pyramid of Corporate Social Responsibility, comprising economic, legal, ethical, and philanthropic dimensions. This framework underscores the multifaceted responsibilities that corporations should fulfill, with philanthropic efforts extending beyond legal obligations. These theories offer crucial insights into the intricate relationship between CSR and stakeholder considerations.

In exploring the link between CSR and a firm's financial performance, signaling theory emerges as a valuable perspective. Signaling theory posits that firms actively participate in CSR activities to signal robust financial performance and a positive reputation to stakeholders. This signaling effect holds the potential to enhance financial performance by instilling confidence among investors, attracting customers, and fortifying relationships with various stakeholders (Orlitzky, Schmidt, & Rynes, 2003). However, the relationship between CSR and financial performance is nuanced and influenced by factors such as the nature and intensity of CSR activities, industry context, and the motivations behind engaging in CSR (McWilliams & Siegel, 2001). Thus, while signaling theory offers valuable insights, it is imperative to consider the complexities inherent in the relationship between CSR and financial performance.

## CSR and Financial Performance

The literature on Corporate Social Responsibility (CSR) and Financial Performance (FP) presents mixed findings. Some studies demonstrate a positive link between CSR and profitability, while others suggest an inverse relationship. In the Chinese context, [Zhou, Pan, and Wang \(2015\)](#) found a positive correlation between CSR and financial profitability. [Cavaco and Crifo \(2014\)](#) identified a positive impact of CSR on Return on Assets (ROA), using CSR dimensions as independent variables. [Flammer \(2013\)](#) illustrated a positive relation between CSR and financial performance, with shareholders responding favorably to eco-friendly initiatives. [Sheikh \(2019\)](#) discovered a positive impact of CSR on firm value, particularly in highly competitive environments.

Moreover, research supports a virtuous circle between social and business performance, emphasizing the role of slack resources in resolving conflicts during challenging times. Ethical managers recognize the benefits of CSR, skillfully applying it to maximize shareholder interests. [Cheng, Lin, and Wong \(2016\)](#) found that a company's past performance significantly and positively influences independent CSR reporting, leading to a subsequent positive correlation between CSR disclosure and performance.

However, contrasting results emerge in some studies. [Barnea and Rubin \(2010\)](#) argued that individuals within the organization may prioritize excessive CSR initiatives at the expense of business interests. [Adegbite, Guney, Kwabi, Tahir, et al. \(2019\)](#) highlighted the complexity of the CSR-FP relationship, suggesting a non-linear association. These discrepancies stem from variations in variables and data limitations across different companies and industries. Given the mixed results in the literature, the study tests the following hypothesis in the context of Pakistan:

*H1a: Corporate Social Responsibility has a significant impact on the Financial Performance (ROA)*

*H1b: Corporate Social Responsibility has a significant impact on the Financial Performance (ROE)*

*H1c: Corporate Social Responsibility has a significant impact on the Financial Performance (EPS)*

*H1d: Corporate Social Responsibility has a significant impact on the Financial Performance (NPM)*

## Financial Distress and Financial Performance

Financial distress is frequently linked to a weakened financial structure, posing heightened financial risks for businesses. [Wu et al. \(2020\)](#) note that highly leveraged companies often experience diminished managerial decision-making power, leading to increased agency costs and a greater propensity for risky decisions. [Jandik and Makhija \(2005\)](#) similarly discovered a negative correlation between a poorly structured debt and firm performance, particularly after unsuccessful acquisitions. The impact of financial distress on firm performance is exacerbated during financial crises, as evidenced by [Bouslah, Kryzanowski, M'Zali, et al. \(2018\)](#) emphasizing a notably more negative correlation in the

post-crisis period.

Conversely, literature indicates that Corporate Social Responsibility (CSR) can positively influence a firm's reputation and rating, resulting in reduced financing barriers and enhanced operational benefits. Previous studies have explored the relationship between financial distress and business or social performance (Chollet & Sandwidi, 2018). In the realm of Chinese manufacturing, financial distress has been examined as a moderator in the relationship between firm performance and CSR. It was observed that highly leveraged firms, prioritizing shareholder interests, face challenges in translating CSR efforts into corporate performance compared to financially stable firms. Consequently, this study introduces a novel perspective by incorporating financial distress as a moderating factor in the relationship between CSR and financial performance. Therefore, the following hypotheses are proposed:

*H2a: Financial distress moderates between CSR and financial performance (ROA).*

*H2b: Financial distress moderates between CSR and financial performance (ROE).*

*H2c: Financial distress moderates between CSR and financial performance (EPS).*

*H2d: Financial distress moderates between CSR and financial performance (NPM).*

## Research Methodology

In the present research, we use the panel data of 48 companies (listed in PSX) from the year 2017 to 2022. The data was collected from manufacturing and financial sector through their annual reports. These companies were selected based on the continuous CSR activities and uninterrupted annual report publications. The study utilizes a multiple regression model to examine relationships between CSR, financial distress and financial performance. Following regression model is used:

$$ROA_{it} = \alpha_{0it} + \beta_1 CSR_{it} + \beta_2 FD * CSR_{it} + \beta_3 \lambda_{it} + e_{it} \quad (1)$$

$$ROE_{it} = \alpha_{0it} + \beta_1 CSR_{it} + \beta_2 FD * CSR_{it} + \beta_3 \lambda_{it} + e_{it} \quad (2)$$

$$EPS_{it} = \alpha_{0it} + \beta_1 CSR_{it} + \beta_2 FD * CSR_{it} + \beta_3 \lambda_{it} + e_{it} \quad (3)$$

$$NPM_{it} = \alpha_{0it} + \beta_1 CSR_{it} + \beta_2 FD * CSR_{it} + \beta_3 \lambda_{it} + e_{it} \quad (4)$$

Whereas, return on assets (ROA), return on equity (ROE), earning per share (EPS), and net profit margin (NPM) are used as the proxies of financial performance. CSR is the corporate social responsibility used as predictor, FD is financial distress used as moderating variable.  $\lambda$  denotes control variables, include leverage, tangibility, no. of operating years, and total assets. The measurement of all the studied variables are explicated in the given table A.

## Data Analysis

### Descriptive Statistics

Descriptive statistics offer an overview of key study variables. Manufacturing firms, on average, achieved an 8.5% return on assets (ROA) and a high 41.2% return on equity (ROE). Earnings per share (EPS) averaged Rs. 33.32, while the net profit margin (NPM) was -19.689, indicating average losses. Corporate Social Responsibility (CSR) scored 3.80 on average, reflecting companies' CSR commitment. Financial distress (FD), measured by a Z-score with a mean of 4.157, exhibited positive skewness (1.714) and kurtosis (3.20). Control variables showed an average debt-to-equity ratio (LVG) of 50.6%, tangible fixed assets ratio (TNG) of 0.466, and an average business tenure (NOPY) of 41.7 years. Long-term assets (LTA) averaged 7.777. These statistics provide a baseline for understanding the financial performance, CSR, and financial distress levels in the sample, serving as a foundation for further analysis of the CSR-FP relationship in the context of FD.

**Table A**  
Measurement of the variables

Variables	Proxies	Formula to compute Proxies
Financial Performance	ROA	Net Income / Total Assets
	ROE	Net Income / Total Equity
	EPS	Net Income / Total # of shares
	NPM	Net Income / Total Sales
	X1	(Current Assets - Current Liabilities) / Total Assets
Financial Distress	X2	Retained Earnings / Total Assets
	X3	EBIT / Total Assets
	X4	Total # of Shares / Total Liabilities
CSR	X5	Total Sales / Total Assets
	Log of CSR	Log (CSR)
Control Variable	Leverage	Total Liabilities / Total Assets
	Tangibility	Fixed Assets / Total Assets
	Numbers of Operating Years	Operating Year
	Log of Total Assets	Log (Total Assets)

**Table 1**  
Descriptive Statistics

Variable	Manufacturing Sector		Financial Sector	
	Mean	Std. Deviation	Mean	Std. Deviation
ROA	0.085	0.128	0.011	0.029
ROE	0.412	2.823	0.186	0.564
EPS	33.328	60.264	10.26	6.336
NPM	-19.689	282.962	0.131	0.059
CSR	3.806	1.658	4.398	1.476
LVG	0.506	0.218	0.941	0.0143
TNG	0.466	0.224	0.064	0.0156
NOPY	41.70	21.066	35.50	18.16
LTA	7.777	0.543	9.047	0.467

In addition, financial sector companies, on average, achieved a 1.1% return on assets (ROA) and a high 18.6% return on equity (ROE). Earnings per share (EPS) averaged Rs. 10.260, and the net profit margin (NPM) was 0.131. Corporate Social Responsibility (CSR)

scored 4.398 on average, indicating the typical CSR commitment level. Financial distress, measured by the Z-score, had an average of 0.578, with negative skewness (-2.101) and positive kurtosis (3.695). Control variables showed an average debt-to-equity ratio (LVG) of 94.1%, tangibility (TNG) at 0.064, average business longevity (NOPY) of 35.5 years, and total assets (LTA) averaging 9.04. These concise statistics provide a thorough understanding of financial performance, CSR, and financial distress in the sample, facilitating further analysis of their interrelationships.

### **Panel ordinary least square (POLS):**

In this study, the analysis is limited to a dataset encompassing six years of financial data from 48 companies. Given that the number of observations (N) exceeds the number of time periods (T), the application of panel unit root analysis is not appropriate. Consequently, the study opts for a direct utilization of panel ordinary least squares. Notably, a different approach is taken in the analysis of manufacturing and financial firms, recognizing the divergent dynamics inherent to these sectors. By conducting separate analyses for these two distinct categories of companies, the study aims to capture and account for the unique influences and trends shaping their financial performance, thereby enhancing the precision and relevance of the findings.

Table 2 presents the outcomes of a Panel Ordinary Least Squares (POLS) regression conducted on manufacturing firms, exploring the relationships between Corporate Social Responsibility (CSR), control variables, and financial performance indicators. The results highlight several significant findings. CSR exhibits a positive and statistically significant impact on Earnings per Share (EPS) with a coefficient of 6.129 and a t-statistic of 2.533, suggesting that higher CSR commitment is associated with increased earnings per share. Additionally, the interaction term between Financial Distress (FD) and CSR is positively significant for Return on Assets (ROA) and EPS, indicating that the joint effect of financial distress and CSR positively influences these variables. Control variables demonstrate noteworthy impacts, particularly Total Assets (LTA), which has a substantial positive influence on all financial performance indicators, and Leverage (LVG), which negatively affects Return on Assets (ROA). The F-statistics for each dependent variable are statistically significant, validating the overall robustness of the model. These findings collectively underscore the relevance of CSR, the interplay with financial distress, and the significance of control variables in shaping the financial performance of manufacturing firms.

Table 3 presents the results of a Panel Ordinary Least Squares (POLS) regression for financial firms, with the dependent variables being Return on Assets (ROA), Return on Equity (ROE), Earnings per Share (EPS), and Net Profit Margin (NPM). The findings reveal nuanced relationships between the variables. Corporate Social Responsibility (CSR) shows minimal impact across all financial performance indicators, with coefficients ranging from 0.001 to 0.018 and t-statistics indicating no statistical significance. In contrast, control variables demonstrate varying influences. Total Assets (LTA) has a significant positive impact on EPS, suggesting larger total assets enhance earnings per share. Leverage (LVG) exhibits a negative impact on ROA and ROE, indicating that higher leverage is associated with lower returns. Operating Years (NOPY) negatively influences ROE and

exhibits a significant negative impact on NPM, implying that longer operational histories may lead to diminished profitability. Tangibility (TNG) is significant for ROA, suggesting that a higher ratio of tangible fixed assets positively impacts return on assets. The interaction term between Financial Distress (FD) and CSR is not statistically significant for any dependent variable, implying that the joint effect of financial distress and CSR is not discernibly influential in financial firms. Overall, the F-statistics, which test the overall significance of the model, indicate statistical significance across all dependent variables, suggesting that the model is collectively robust for explaining the financial performance of financial firms.

The findings from Tables 2 and 3 underscore the varied impact of Corporate Social Responsibility (CSR) on financial performance across manufacturing and financial sectors. In manufacturing, CSR positively influences Earnings per Share (EPS), emphasizing its role in enhancing shareholder value. Financial firms exhibit a nuanced relationship with CSR, suggesting sector-specific dynamics. Control variables, notably Total Assets (LTA), play a pivotal role in shaping financial outcomes in both sectors. The significance of the interaction term with Financial Distress (FD) further highlights the complex interplay between CSR and financial health. These insights contribute to sector-specific strategies for optimizing CSR benefits and financial performance.

**Table 2**  
POLs (Manufacturing Firms)

Dep Var	ROA			ROE			EPS			NPM		
	Beta	t-Stats	Prob.	Beta	t-Stats	Prob.	Beta	t-Stats	Prob.	Beta	t-Stats	Prob.
CSR	0.005	1.065	0.288	0.076	0.654	0.514	6.129	2.533	0.012	2.182	0.217	0.829
LTA	0.081	5.156	0.000	-0.276	-0.752	0.453	5.770	0.760	0.448	277.017	8.776	0.000
LVG	-0.105	-2.823	0.005	2.853	3.291	0.001	9.418	0.525	0.600	108.138	1.450	0.148
NOPY	-0.001	-1.842	0.067	0.005	0.597	0.551	-0.267	-1.457	0.147	-1.237	-1.622	0.106
TNG	-0.042	-1.167	0.244	1.012	1.207	0.229	-60.888	-3.510	0.001	235.812	3.268	0.001
FD * CSR	0.007	3.116	0.002	0.091	1.751	0.081	4.300	4.073	0.000	13.941	3.175	0.002
<b>F-statistic = 8.5 (0.000)</b>			<b>F-statistic = 2.30 (0.000)</b>			<b>F-statistic = 5.495 (0.406)</b>			<b>F-statistic = 19.824 (0.000)</b>			

**Table 3**  
POLs (Financial Firms)

Dep Var	ROA			ROE			EPS			NPM		
	Beta	t-Stats	Prob.	Beta	t-Stats	Prob.	Beta	t-Stats	Prob.	Beta	t-Stats	Prob.
CSR	0.001	0.252	0.803	0.018	0.257	0.799	0.929	1.679	0.101	-0.007	-1.167	0.250
LTA	-0.012	-0.962	0.342	-0.068	-0.293	0.771	6.860	3.716	0.001	0.092	4.774	0.000
LVG	-0.345	-0.768	0.447	-4.884	-0.565	0.575	-45.298	-0.661	0.512	-1.764	-2.463	0.018
NOPY	0.021	-0.392	0.697	-0.005	-0.646	0.522	0.024	0.417	0.679	-0.002	-3.513	0.001
TNG	0.092	0.302	0.765	3.311	0.566	0.574	-77.125	-1.664	0.104	-0.295	-0.609	0.546
FD * CSR	0.009	1.209	0.233	0.222	1.531	0.133	2.253	1.926	0.061	-0.009	0.012	-0.738
<b>F-statistic = 0.456 (0.000)</b>			<b>F-statistic = 0.272 (0.000)</b>			<b>F-statistic = 8.99 (0.000)</b>			<b>F-statistic = 5.70 (0.000)</b>			

## Conclusion and Recommendations

The present research confirms the relationship of Corporate Social Responsibility (CSR) on the financial performance of manufacturing and financial sector companies. The inte-

gration of CSR activities acts as a favorable signal to stakeholders, resulting in advantageous outcomes, including reduced borrowing costs, favorable tax policies, and enhanced employee motivation and productivity. Notably, the study underscores the heightened significance of the CSR-Financial Performance (FP) relationship for companies with lower bankruptcy risk, emphasizing the critical need to concurrently manage CSR initiatives and financial health.

In light of the obtained findings, firms both manufacturing and financial sectors should tailor CSR initiatives to align with their distinct dynamics. Manufacturing firms can leverage CSR to enhance shareholder value, focusing on initiatives that positively impact Earnings per Share (EPS). Financial firms, while showing a minimal impact of CSR, can explore targeted initiatives that resonate with their stakeholders. Additionally, prudent management of control variables, especially Total Assets (LTA), is crucial for optimizing financial outcomes. Firms should continually evaluate and adapt CSR strategies in response to changing sector dynamics for sustained financial success. Nevertheless, it is crucial to acknowledge certain limitations inherent in the study, such as the broad measurement of CSR without a detailed analysis of its individual dimensions and the focus on a specific industry and region. Future research endeavors should aim to scrutinize the distinct impacts of various CSR dimensions, extend the study's scope to diverse contexts, and explore the long-term effects and underlying mechanisms of the identified relationships.

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