# Impact of Social and Environmental Practices on SME Business Performance

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### Abstract

Influence of social and environmental practices in driving business growth in case of big companies is evident. However for small and medium enterprises these aspects of business operations are grossly neglected. SMEs contribute immensely to the economic progress of a country. But a large percentage of the SMEs fail within few years of incorporation. In our paper we have tried to develop a model taking a sample of 200 SMEs from Indian leather and chemical sectors and find out how factors like collaborative approach of operation at industry level and government intervention at policy level impact their sustainability performance and how in turn their improved social and environmental performance help them to drive sustainable business growth. Empirical results of our study reveal that both government intervention and collaborative operation positively influence the firm's sustainability performance and in turn company's business performance is positively impacted by enhanced sustainability performance. Company size was found to have a moderating effect on this relationship

### Introduction

Influence of sustainability practices in driving business excellence in case of big corporate houses and multinational companies is evident. These companies have their sustainable practices regularly audited and in most cases the results form a part of their annual report. However in case of small and medium enterprises sustainability practices especially those related to social and environmental aspects of their operations are grossly neglected. This is specifically true for SMEs of emerging markets. Earlier studies have identified current level of social and environmental initiatives being practiced by SMEs predominantly in the context of developed nations (**Evans and Sawyer, 2010**), but their contribution in improving the business performance of the SMEs or in enhancing their competitive advantage is not very evident. Earlier researchers have shown that, apart from government intervention some of the important factors that help sustainable growth of SMEs are development of entrepreneurial skill (**Petkovic et al, 2016**), partnership and collaboration, internationalization and opportunity for innovation (**Lamberty & Noci, 2012**).

We restricted our study in SMEs only. This is firstly because considerable research gap exists in this area. Most of the research in the field of sustainability performance and firm performance association, analyzed this relationship for big companies in developed countries (Goyal, Rahman & Kazmi, 2015). Secondly, in spite of their immense contribution to the economy of a country a large percentage of SMEs in most of the countries encounter bankruptcy within few years of incorporation or remain stagnant within a small scale of operation (Reeg, 2013). SMEs together account for close to 90% of global businesses and create 50-60% of the total employment worldwide. Thus it is important to study the sustainability factors of this huge sector with potential growth possibilities.

The objective of this paper is to develop a model and find out how factors like collaborative approach of operation at industry level and government intervention at policy level impact the sustainability performance of SMEs in India and how in turn the improved sustainability performance help to drive their business growth.

Sustainability literature has focused on main three dimensions of business sustainability namely economic sustainability, environmental sustainability and social sustainability. For obvious reason economic viability has remained the main objective of business development. In our current study we have considered other two so far neglected but equally important dimensions of sustainability that is environmental and social responsibilities of business operations.

## Theoretical Framework and Hypothesis Development

From the literature it is evident that although the term corporate sustainability is not very familiar among the SMEs, concept wise understanding of CSR or sustainability does exist among them. In general SMEs consider sustainability as a means to maintain a balance of social, economic and environmental demands and also to respond to the stakeholders' expectations to reduce social or environmental impact of their business operations and build competencies for creating positive impact on society and environment (Linh, 2011). SME managers who consider CSR as a business opportunity can better balance their commitment to sustainability without compromising their economic performance, than those who consider CSR as a cost burden (Martina and Martin 2011).

In order to develop a framework for business performance through sustainable practices we first define different measures and constructs used in our proposed model and subsequently derive their interrelations to develop research hypothesis with evidences from existing literature

#### Measures

### Government Intervention

Government intervention signifies how government through policy formulation, issuance of SME specific guidelines and standards, credit facilitation, conduction of different educational and promotional programs, development of entrepreneurial skill, sustainability management strategy and tools can boost up responsible business behaviour on the part of SMEs. Government need to intervene through soft policies and also promote development of sustainability management tools to better suit the SME (Matthew & Johnson 2015).

Earlier studies have identified factors like absence of institutional environment, lack of policy support and unavailability of frameworks and guidelines as some of the major barriers to sustainability management activities for SMEs in the emerging markets (Alexander et al, 2010). Role of government is important here. Government through policy regime, issuance of guidelines and standards, development of sustainable management tools can boost sustainable growth in SMEs. Geographic spread of the SMEs is much wider in India which can effectively be leveraged in the process of inclusive growth. Government can play a significant role by introducing some kind of mandatory obligations of responsible business practices on the SMEs. Alexander et al (2010) focussed on government intervention and cooperation of the external facilitators to boost employee morale and relationship with customer and community. Codes of conduct transmitted from trans-national companies and an active government role is necessary for boosting sustainability practices in SMEs in India (Nimruji, 2012). Banjo & Doren (2012) suggested that government policies and programs to encourage small firms in Philippines to become sustainable should go beyond financial forms of assistance. On Government part enforcing labour code is also essential (Trans and Jeppesen 2016). Also by conducting funded awareness programmes on sustainability for SMEs and by providing opportunities for innovation government can stimulate adoption of sustainability practices among SMEs. We integrate these views to develop our first research proposition that government intervention positively influence sustainability performance.

Government intervention is a factor external to SMEs. But to measure the effectiveness of government intervention on SME business we perceive it from SME point of view and measure the construct based on the effort made by the SMEs to leverage from government intervention. To develop the construct 'Government Intervention' we considered factors like SMEs' level of awareness about and adherence to different government policies on CSR, environment laws and labour practices, their awareness about available guidelines, tools & framework for managing sustainability practices in the organization. Also their participation in various social

and environmental initiatives of government was also noted to assess the effectiveness of these interventions.

#### Sustainability Performance

We followed existing sustainability assessment questionnaire (Rebeco Sam) and guidelines to frame questions and constructs related to *Sustainability Performance*. Under social dimension of *Sustainability Performance* we considered factors like work force diversity indicated by percentage of female workers, percentage of workers from minority community, parity of remuneration between male and female employee, organizational health and safety like provision of health insurance coverage, protection against accidents, adherence to the workplace health and safety norms, work environment conducive to perform well with sufficient ventilation, light and clean and hygienic sanitary system. Under the Environment dimension of *Sustainability Performance* we considered factors like eco-friendly environment within the factory premise, monitoring and control of the emission of Green House Gases, waste management practices like treatment of water or other effluents before disposal.

High value of factor loading and Cronbach Alpha (> 0.8) establishes the validity of the above construct (Ref Table 1)

Hypothesis 1: Government Intervention can positively influence firm's Sustainability Performance for SMEs.

## Collaborative Approach of Operation

For SMEs considering their resource constraint, collaboration is the only way to their sustenance and also the best way to realise their sustainability goals. Santos (2014) mentioned that challenges like resource constraints can be overcome through collaboration. However alliances and networks can only be leveraged to solve common problems and share best practice CSRs if the SMEs are willing, able and prepared for disclosing and sharing of environmental information which is the precondition for decreasing the information asymmetry in this field (Jozica, 2004). Literature has suggested that through collaborative operations SMEs can become instrumental in transmitting sustainability requirements of their customers and thus effectively diffuse the sustainability practices across the supply chain (Silvia et al, 2013). Being a part of the social network, proximity and reciprocity with local communities help them to address the resource and capacity challenges to implement effective sustainability practices. Individuals with very positive attitudes about their local communities were more likely to serve in leadership positions and make financial and technical contributions to the community (Margaret et al, 2010).

A shift from auditing and monitoring to more open dialogue among different stakeholders especially suppliers and customers will prevent the SMEs to resort to unethical practices of mock compliance (Huq et al, 2014). Growth through proper communication to all stakeholders including the internal stakeholders like employees and external stakeholders like supplier, customer and local community is necessary for sustainable development (Cader and Leatherman, 2011). These views put together form the basis of our second research proposition that collaborative operations help to improve sustainability performance.

In line with the recommendations available in the literature we develop the construct 'Collaborative Approach of Operations' considering the factors like firm's registration with SME association and trade promotion councils, formation of cluster and sharing data related to sustainability best practices within the SME cluster, following any sustainability practice requirements from customers, inclusion of sustainability practices in supplier selection criteria, sharing of sustainability performance data externally through websites or reports to customers. High value of factor loading and Cronbach Alpha (> 0.8) establishes the validity of our construct (Ref Table 1)

Hypothesis 2: Collaborative Approach of Operation will positively influence firm's sustainability performance in SMEs.

#### **Business** Performance

Financial Performance is a well recognized proxy variable to assess overall business performance of an organization. To determine business performance for big corporations both market variables and accounting variables were considered from case to case basis. But in most cases SMEs are private partnerships or small unlisted public companies. Almost all the existing literature captured SMEs' financial performance by respondent's perception on selected financial parameters on a 5 or 7-point Likert Scale and then extracting 1 or 2 factors by factor analysis (Torugsa and Wayne, 2012; Tang and Tang, 2016; Banjo and Doren, 2012). In our case we interviewed the finance department of the respective SMEs and using a 5-point Likert scale asked them to rate the trend of sales growth, and profitability over last five years.

Attempts have been made to relate the sustainability performance with financial performance of the firm in case of big corporate houses and for some SMEs in developed countries. But for SMEs in developing market like India it is not a well researched area. With empirical evidence from Johnson & Johnson, Jessica & Seleshi, (2013) suggested that profitability can be sustained for a long period of time if economic performance is effectively integrated with social and environmental goals, as part of the business strategic planning process. In Indian context Ghosh (2013) suggested that superior sustainability performance leads to superior financial performance. These findings form the basis of our third research proposition where in we suggest that improved sustainability performance will drive financial performance in case of SMEs as well in the long run.

Hypothesis 3: Improved Sustainability Performance will lead to improved Business Performance.

#### Control Variable

Since in most of the earlier studies the relationship between sustainability performance and firm performance has been established for big companies in case of SMEs we wanted to test if company size has any moderating effect on this relationship. This forms the basis of our fourth research proposition that company size influences the relationship between sustainability performance and firm performance. Company size in terms of investment in plant and machinery has been used as a control variable influencing the relationship between the sustainable performance and business performance. Sample firms were divided in two size groups based on the definition of MSME (MSME Development Act, 2006) where firms having investment in plant and machinery more than 2.5 million (twenty five lakh) rupees but less than 50 million (five crore) rupees are considered small firms and firms having investments more than 50 million (five crore) rupees and not exceeding 100 million (ten crore) rupees are considered medium firms. Micro firms are not included in our sample set as they are too small to leverage from any sustainability practices. Also approachability for micro firms was difficult

Hypothesis 4: Company size has a moderating effect on the relationship between Sustainability Performance and Business Performance.

Hypothesis 4a: Sustainability performance has a stronger positive impact on business performance for medium sized companies than the small sized firms.

Figure 1: Proposed Model and related Hypotheses

# Methodology

#### Sample

A primary survey was conducted to collect the required data for our study. Our survey questionnaire comprised of 10 observed variables. A high level estimation of sample size was done considering 20 data points per observed variable. Since we have 10 observed variables the estimated sample size came to be 200. We short listed around 400 SMEs expecting 50% response rate. In the list we excluded micro organization considering the difficulties in approaching these firms and restricted our sample among the small and medium firms. Size categorization was made as per the definition of MSME by Ministry of MSME for manufacturing sector. The list of SMEs in leather technology, textile and chemical industries were collected from authorized SME associations and export promotion councils (CAPEXIL, CHEMEXCIL, ILPA & CLE). The reason for focusing on leather, textile and chemical industries is mainly the higher concentration of their clusters in the areas of our geographical proximity and reasonable contribution to these SMEs in environmental degradation.

Around 250 of the firms could be contacted over telephone requesting an appointment. Finally managers from 225 SMEs could be successfully interviewed. Interviews were done in person. Around ten months were required to complete visiting 225 SMEs. Three main clusters in the outskirt of the city of Kolkata were visited apart from visiting some SME offices scattered in the central part of the city. Before meeting the SME manager a fair idea of their operation and other relevant information were collected from their websites. This prior knowledge about the company helped us to reduce the interview time and also aroused interest of the respondents.

The data items required for this study were adapted from well recognized sustainability assessment tools and frameworks available in the market, which are predominantly being used for sustainability audits of big corporate houses (CSA Guide – RobecoSAM, 2016; Graubner et al, 2016; ARCHIBUS Environmental Sustainability Assessment, 2016; Veleva et al, 2003; Togo & Lotz, 2009). Before starting the interview of the SME managers, the questionnaire was validated for their relevance to SME operations by two senior and experienced managers of SME associations. Due to the lack of sufficient secondary data, use of self-diagnostic and self-assessing questionnaire is a common practice in studies of SMEs (Nejati et al, 2014). Besides, given the nature of small business, owners or managers make all the critical management decisions of SME firms. Hence managers of SMEs are assumed to have the most comprehensive knowledge about the firm practices and strategies. Thus in all cases either the owner or the manager next to him was interviewed.

#### Measurement model

Before the main data collection activity a pilot survey was done with 40 SMEs to fine tune our questionnaire. With the responses collected from initial 40 firms a reliability test and exploratory factor analysis using Principal Component Analysis with Varimax rotation was done. Factor loadings for all the constructs above 0.7 and Cronbach's alpha for the finalized constructs ranging from 0.87 to 0.99, confirm internal reliability and convergent validity of the constructs and indicates adequate contribution of items to the overall scale (Table I).

Factors	Items	Factor Loadings	Cronbach-α
Government Intervention (GOV)	2	Max: 0.750 Min: 0.725	0.791
Collaborative Operation (COL)	2	Max: 0.723 Min: 0.711	0.754
Sustainability Performance (SUS)	4	Max: 0.762 Min: 0.713	0.823
Business Performance (BP)	2	Max: 0.879 Min: 0.804	0.788

## Table I : Convergent validity of the Construct

Also estimated correlations between the latent variables shown in Table II were well below the recommended cut-off of 0.70 (Pallant 2007), meaning that discriminant validity was established for all constructs in the measurement model. Both the convergent and discriminant validity results demonstrate the feasibility and theoretical soundness of our measurement model.

Variables	Mean	SD	COL	GOV	ESP
COL	3.21	0.59			
GOV	3.45	0.68	0.073		
SUS	3.09	1.03	0.452	0.298	
BP	3.82	0.75	0.443	0.548	0.503

Table II: Means, Standard Deviations and Correlations

## **Analyses and Results**

The model in the current study consists of multiple variables whose relationships are not well-defined and

form various inner models. Besides, in the current study's measurement model, there could be random error caused by respondent fatigue and systematic error caused by variance attributable to the measurement method. Hence, to establish the extent to which the proposed model represents an acceptable approximation of actual relationship, analysis of the collected data was performed using structural equation modeling (SEM) with IBM SPSS AMOS v20.0 and various fit indices were examined.

We first tested our unconstrained measurement model. The CFA showed that this measurement model was a reasonable fit for the data with  $\chi^2 = 185.5$ , RMSEA = 0.049, CFI = 0.963, NFI = 0.956. Our sample being a smaller one we used CFI and NFI as they are less sensitive to sample size (Hair et al, 1998; Ho 2006).

Table III: Confirmatory Factor Analysis for validity and reliability of construct measures

Constructs and measurement variables	Standardized measurement variable-constru
	Medium Enterprises
Government Intervention	
AGP : Awareness of and adherence to government policies and programs	0.82
PGI: Participation in social and environmental initiatives of government	0.83
Collaborative Operation	
SCL : Sharing of sustainability best practices within the SME Cluster	0.81
SRC : Sustainability requirement of supplier and customer	0.77
Sustainability Performance	
WFD: Work Force Diversity	0.77
OHS: Operational Health and Safety	0.78
ENV: Eco-friendly Environment	0.75
WMT: Waste management	0.73
Business Performance	
SGR : Sales Growth Rate	0.89
PFT : Profitability	0.93
Unconstrained model: $\chi 2 = 181.48$ , CFI = 0.96, NFI = 0.96, RMSEA = 0.05	Unconstrained model: $\chi 2 = 181.48$ , CFI =
Constrained model: $\chi 2 = 201.63$ , CFI = 0.92, IFI = 0.93, RMSEA = 0.07	Constrained model: $\chi^2 = 201.63$ , CFI = 0.

All of the indicators had statistically significant standardized loadings on their intended constructs (p < 0.01).

Next to check moderating effect of company size, we constrained our measurement model with company size and separately conducted CFA for Small and Medium firms using multi-group analysis. Equivalent measures and factor patterns in two groups confirmed the factor structure invariance across the two company size groups (Table III) and allowed us to proceed with the same measurement model for the path analysis of both the groups.

After ensuring adequate fit for the measurement model, we tested our proposed structural model in Figure 1 separately for Medium and Small SMEs. We compared the results for each group which is given in Table IV. In both the cases the model provided a good fit (Table V)

Table IV: Individual Model Fit

	Medium Sized Firms	Small Sized Firms
Chi-Square	344	303.2
IFI	0.93	0.94
CFI	0.92	0.93
RMSEA	0.05	0.06

Hypotheses	Path	Path Coefficients	Path Coefficients	Decision
		Medium Enterprises	Small Enterprises	
H1	$GOV \rightarrow SUS (\beta_1)$	$0.39^{***}$	$0.45^{***}$	Supported
H2	$\text{COL} \rightarrow \text{SUS}(\beta_2)$	$0.61^{***}$	$0.58^{***}$	Supported
H3	SUS -> OBP $(\beta_3)$	$0.74^{**}$	$0.21^{**}$	Supported

Table V: Path Coefficient for Individual Model

\*\* p < 0.01; \*\*\* p < 0.001

The path coefficients from Government Intervention and Collaborative Operation to Sustainability Practices are similar across both the size categories. For Government Intervention positive results 0.39 for medium firms (p < 0.01) and 0.45 for small firms (p < 0.01) support our hypothesis 1. For Collaborative Operation positive path coefficients 0.61 for medium firms (p < 0.001) and 0.58 for small firms (p < 0.001) support our hypothesis 2. Again positive path coefficients from Sustainability Performance to Business Performance in both size groups support our hypothesis 3. But this result differs across the two samples. It was 0.82 (p < 0.001) for medium sized firms and was 0.21 (p < 0.001) for small sized firms.

Figure 2 : Structural Model to test the Proposed Empirical Relationship

An insignificant difference in chi-square between the constrained and unconstrained models suggests equal path coefficients across the two samples, whereas a significant difference in chi-square would imply that the path coefficient is statistically different between the two samples. The results are shown in Table VI.

Table VI: Results of Multi-group Comparisons

Constraints	$\chi^2$ difference
$\overline{\text{GOV}} \rightarrow \text{SUS}(\beta_1)$	$5.6^{*}$
$\text{COL} \rightarrow \text{SUS}(\hat{\beta}_2)$	$3.8^{*}$
SUS -> OBP $(\beta_3)$	$23.2^{***}$

\* p < 0.1; \*\*\* p < 0.001

For the government intervention to sustainability performance path, the difference in chi-square is 5.6 (p < 0.10). Similarly, for the collaborative operation to sustainability performance path, the difference in chi-square is 3.8 (p < 0.10). Thus the differences in these relationships between medium and small firm samples are not statistically significant. However, the difference in chi-square is 23.2 (p < 0.001) for the sustainability performance-to-business performance path. These results suggest a significant difference in the relationship between sustainability performance and business performance and confirm our hypothesis 4 that company size has a moderating effect on the relationship between Sustainability Performance and Business Performance.

## Discussion

The empirical results of our study reveal that government intervention positively influences the sustainability performance of an SME which in turn positively influences business performance of the organization. This implies that government role is instrumental in making the SMEs more responsible towards the social and environmental impacts of their operations. This result is in line with the earlier studies in the context of other geographical areas. Regulatory and legislative interventions by the government and increased number of awareness programs, related articles and journals have boosted up some socially responsibility practices in SMEs in Romania (Violeta and Ileana, 2011). Also the market pressures and laws are major key drivers for CSR in SMEs (Elena et al, 2011). Mohammed et al (2016) suggested that Government action and

introduction of green taxes, high energy price are some of the factors promoting environmental practices in SMEs in UK.

Our results also show that collaborative approach of operation impacts sustainability performance in SMEs in a positive way. Enhancement of sustainability performance through collaborations has been well supported in earlier studies. A cluster approach or a network model can address the limitations faced by the SMEs while trying to implement CSR individually (Heidi and Shankar, 2011). Sustainability practices can be strengthened by forming a forum where in different NGO can facilitate sharing CSR best practices and can jointly address different sustainability related issues and challenges (Janet and Nina, 2010). A network perspective has much to offer in facilitating the transition towards a network level culture of sustainable business practices (Jamsa et al, 2011). Operating together, in the form of clusters, or with the support of NGOs in introducing CSR can address the resource constraint and implementation challenges faced by the SMEs (Magdalena and Popowska, 2015).

The result of our analysis with data from 225 Indian MSME also supports that enhanced sustainability performance help the SME organizations improve their business performance. This means that SMEs also through communication of their sustainable and responsible business practices can create a positive image in the society which in turn help them to achieve customer loyalty, employee satisfaction which ultimately lead to improved business performance. This finding has also been supported by earlier researcher for SMEs in different parts of the world. Heather and Gapp (2014), in Australian SME context has mentioned that greater social and environmental engagement have directly attributed to the SMEs' improved business performance. In Netherlands, SMEs with sustainability integrated in their innovation processes show improved economical performance (Hilke, 2010). Luis and Ricardo (2014) empirically established the existence of a valid positive relationship between companies' social performance and key business results for SMEs in Portugal.

Moreover our results on moderating effect of company size on the relationship between the sustainable performance and business performance shows that sustainability performance in driving business growth is more effective in case of medium size companies than smaller firms. Smaller companies have an added advantage of structural flexibility over bigger firms and are more driven by the individual value system of their owner managers. This suggests that a strong value system and an ethical consideration on the part of the SME owner will help in driving sustainable business practices in the organization. Moreover small firms need to bring in more internal discipline and better stream line their operations at individual firm level before leveraging from collaborative operation at industry level and government facilitations at policy level.

# **Conclusion and Future Research Scope**

For big organizations violation of human rights, environmental laws or social norms will not allow corporations run any longer. But for SMEs there is lack of transparency in their business operations and therefore the problem is more intense. For example, labour law violation is a major problem in the garment industry of India and Bangladesh. Practices of child labor or unpaid overtime are rampant. Moreover in some of the most polluting industries like leather, dye and other chemical manufacturing SME presence is significant. Laws have been passed to curb the negative impact of SME business operations on environment and society. But SME managers need to understand the importance of responsible business behavior. Running their business operation in a socially and environmentally responsible way may push their profit maximization goal to a back seat in the short run, in the long run this proves beneficial to the company for maintaining a sustainable business growth.

Due to time and resource constraint we had to work with a limited sample consisting of a small set of SME firms located in and around Kolkata, a city in the eastern region of the country. Thus the result might show a geographical bias. Moreover for collaborative approach we have only considered collaborations at national level. In Asian countries the internationalization effort in SMEs is restricted to exporting only. Effort should be made to promote the SME sector to equip them to better meet the challenges of globalization and to benefit from the opportunities it offer. Facilitation of trade, intellectual property protection, improved infrastructure are precursors for entering foreign market. In emerging economies, these often act as major

hindrance to participate in global value chain and seize global opportunities. Thus how different forms of international market entry and development, like foreign direct investment, strategic alliances, licensing, subcontracting, franchise arrangements and joint ventures can help the Indian MSME sector to grow in a more sustainable way can be empirically verified.

Sustainability needs to be viewed not in terms of sustainability of individual firm but more broadly in terms of having a sustainable resilient SME business population (Gray and Jones, 2016). Accurate knowledge on how various components of SME business are dynamically interacting with broader socio-economic environment is extremely important for both SME management and government in order to have effective policy formulation and implementation.

India stands apart from developed western economies both economically and culturally. Thus mere replication of strategies and policies may not be feasible or effective in Indian scenario. There is a need for targeted policy interventions, supported by empirical evidence, to stimulate MSMEs growth and harness their potential to be the engines of economic growth for the country.

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