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The mediating effect of stakeholder influence capacity on the relationship between corporate social responsibility and corporate financial performance

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Abstract

Corporate social responsibility (CSR) and corporate financial performance (CFP) has been examined extensively in the literature. Majority of the studies suggested a positive relationship and few others found neutral, negative and/or curvilinear relationships. Hence this development calls for a mediating mechanism on the relationship between CSR and CFP. This paper proposes to provide a framework that explains how and why CSR leads to CFP by promoting a potential mediator namely stakeholder influence capacity (SIC). Based on the literature reviewed, this paper proposes three variables which can be used to implement the framework at firm level. The variables are corporate social responsibility, stakeholder influence capacity and corporate financial performance.

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Keywords: Corporate social responsibility; corporate financial performance; stakeholder influence capacity; positive relationship; mediating effect, variables.

1. Introduction

Corporate social responsibility (CSR) has been acknowledged by many authors, organizations and practitioners. According to Carroll (1979, 1999), CSR means conducting business in a way that is economically

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profitable, law abiding, ethical and socially supportive. Munasinghe and Kumara (2013) explained that CSR offers companies a means by which they can manage and influence the attitude and perceptions of their stakeholders, building their trust and enabling the benefits of positive relationships to deliver business advantages. Barnett (2007) argued that CSR leads to trustworthiness that strengthens the relationship with important stakeholder, thereby reducing the transaction cost and leads to financial gain. In addition, CSR leads to profitability as posited by many scholars (Beurden & Gössling, 2008; Boaventura, Silva, & B&eira-de-Mello, 2012; Margolis & Walsh, 2003; Orlitzky, Schmidt, & Rynes, 2003). Some scholars believed the relationship between CSR and corporate financial performance (CFP) is negative (Brammer, Brooks, & Pavelin, 2006; Wright & Ferris, 1997) and some few believed that the relationship is neutral (Fauzi & Idris, 2009; McWilliams & Siegel, 2000). On the other hand, some studies considering the mixed findings in the relationship, suggest the possible existence of mediating and moderating variables that are not captured in the models (Archie B. Carroll & Shabana, 2010; Crifo, Diaye, & Pekovic, 2013; Rowley & Berman, 2000). Carroll and Shabana (2010) for example suggested that accounting for mediating or situational variables would improve understanding of the relationship. Some studies proved that the relationship between CSR and financial performance is U shaped (Barnett, 2007; Barnett & Solomon, 2006, 2012). Similarly, Barnett (2007) theorized that change in financial earnings to social and environmental responsibility is as a result of variance on firm capabilities, further argue building on the instrumental stakeholder theory that profits to businesses from social responsibility arises from enhanced stakeholder relationships (Jones, 1995). Furthermore, study of Barnett and Solomon (2006) found the association between CSR and CFP is U shaped, and reported two mutual funds that have the highest and the lowest social performance recorded the best financial performance and the firms with moderate social responsibility did the worst. Therefore the argument is the initial cost of CSR leads to the downward sloping of the U shape and as they devoted more funds on CSR the more their finances drains away until the relationship neutralizes and changes to positive as they build the stakeholder influence capacity (SIC) as a result of the increase in CSR (Barnett & Solomon, 2012). However, Stakeholder influence capacity (SIC) is defined by Barnett (2007) as “the ability of a firm to identify, act on and profit from opportunity to improve stakeholder relationships through CSR”. This present study offers a framework that SIC can explain how CSR activities are turned into profit to benefit the firm. The remaining parts of the paper are organized as follows; next part presents the literature review and proposition development, followed by the conceptual framework and finally the conclusion.

2. Literature review

2.1 Corporate financial performance

Corporate financial performance (CFP) is defined as achievement of organizational objectives (Bourguignon, 1995) or as being both productive and efficient (Niculescu, 2003). It was also defined by Lorino (2004) as anything which contribute to ameliorate value-cost couple and not only which contributes to cost decrease or value increase. Furthermore corporate entities must constantly be proving their economic and financial performance to the immediate environment (Dorina, Victoria, & Diana, 2012). Performance measuring is a necessary condition for assuring one’s entity’s progress and the progress that is not measured does not exist (Tatiana and Marioara, 2012). The concept of CFP is influenced by many factors including CSR. The meta analysis of Boaventura et al. (2012) reported that most studies uses return on assets (ROA) to measure CFP almost forty eight percent (48%), followed by return on equity (29%), sales growth (22%), return on sales (16%), contribution margin (15%), Tobins Q (10%), etc. Therefore these developments lead to the conclusion that researchers predominantly use return on asset (ROA) to measure CFP.

2.2 Corporate social responsibility

Corporate social responsibility has been defined by many authors, institutions and corporations differently due to its broader dimension nature. However, Parliamentary Joint Committee on corporations and financial services (PJC, 2006) defined CSR as “the company considering, managing and balancing the economic, social and environmental impact of its activities”. Brine, Brown and Hackett (2007) mentioned the followings to drives companies to take part in CSR; customers’ patronage, government support, risk management, retention of talented employees and cost reduction. Studies revealed the followings to be measurements of CSR. First, CSR was measured using the issued sustainability report. However, this report was criticized by the authors for indicating only the willingness but not the actual social action. Second, using CSR indices such as KLD index and using the corporate social responsible investment fund criteria (Brine et al., 2007). Some authors developed their own measurement of CSR for example a questionnaire (Aupperle, Carroll, & Hatfield, 1985) and adopt or adapt from others (Mulyadi & Anwar, 2012; Murray & Vogel, 1994). In addition, the disclosure in the annual reports of social activities (Aras, Aybars, & Kutlu, 2011; Munasinghe & Kumara, 2013) and the use of CSR announcement as a proxy for CSR (Clacher & Hagendorff, 2012; Nicolau, 2008).

2.3 Corporate social responsibility and corporate financial performance

The concept of CSR has been debated in the literature for decades (Barnett & Solomon, 2012). CSR can be explained as considering, managing and balancing economic, social and environmental impact of firms' business activities (PJC, 2006). However according to Friedman, (1970) the one and only responsibility of business is to generate profit for its shareholders provided they act within the rules of the game by paying tax and obeying the rules and laws of the operating environment, argued that spending resources on CSR drain away the firms' resources and put the company in a competitive disadvantage (Friedman, 1970). However, Freeman (1984) argued that CSR leads to competitive advantage, since the increase in CSR will improve the relationship with their stakeholders and in turn will reduces firms' transaction cost (Jones, 1995), increases market opportunities and pricing premiums (Fombrun, Gardberg, & Barnett, 2000). Ultimately, this situation will result in higher net financial performance. Furthermore, empirical studies found that the relationship between CSR and CFP has been contradicted, with some studies reporting a negative (Brammer, Brooks & Pavelin 2006), some neutral (Aupperle et al., 1985; Fauzi, 2009; Mulyadi & Anwar, 2012) and many positive relationships (Flammer, 2013; Goll & Rasheed, 2004; Tsoutsoura, 2004). The meta-analysis of Orlitzky et al., (2003) for example, reported that CSR is positively related to CFP. The meta-analysis of Margolish and Walsh (2003), also reported that 54 out of the 109 studies examined reported a positive relationship some reported a negative relationship (7/109) some reported a non-significant relationship (28/109) and finally some found combined result (20/109). Boaventura et al., (2012) reported in their own meta-analysis that 65.5% of the studies reviewed reported positive relationship between CSR and CFP, 19% report negative and 31% reported neutral or inexistent relationship. On the general, the relationship between CSR and CFP is having a mixed result but is predominantly positive. Generally, the direct relationship between CSR and CFP is predominantly positive as explained by many meta-analyses (Beurden & Gossling 2008; Boaventura et al. 2012; Orlitzky et al., 2003; Margolish & Walsh, 2003). Therefore the following proposition is advanced:

P1 There is a positive relationship between corporate social responsibility and corporate financial performance

2.4 Corporate social responsibility and stakeholder influence capacity

The stakeholder theory outline the various stakeholders of a firm to include the followings; holding company, industry association, competitors, stockholders, suppliers, customers, government regulation, sales force, unions labor, management, educational institutions and financial institutions (Freeman, 1984). Corporate social responsibility activities have been conducted by companies to improve their relationship with their stakeholders (Barnet, 2007). Stakeholder theory claims that the more a company manages its dealings with the numerous group that have certain interest or stake in the firm, the more prosperous it will be over time (Freeman, 1984). Similarly the instrumental stakeholder theory sees the organization as a nexus of contracts and addresses the capability of a firm to raise its competitive advantage by reducing its cost of contracting (Jensen & Meckling, 1976; Jones, 1995). According to Wicks, Berman and Jones (1999) developing trusting relationship with the various stakeholders help to minimize the cost of contracting. Barnett and Solomon (2012) opined that engaging in socially responsible behaviors forms part of the mechanisms through which firm builds and maintain trusting stakeholder influence. Although the present study was unable to provide any tested empirical evidence of relationship between CSR and

SIC, the above arguments on the influence of CSR activities on improved stakeholder relationship leads the present study to postulate the following proposition:

P2 There is a positive relationship between corporate social responsibility and stakeholder influence capacity

2.5 Stakeholder influence capacity and corporate financial performance

According to a learning organization on stakeholder management, stakeholders were divided into internal (employees, management, control organs and internal shareholders) and external (external shareholders, customers, suppliers, distributors, strategic partners, industry associates, general public, media, politicians, public authorities, education, NGOs and unions) (Hermann, n.d.). Instrumental stakeholder theory, an essential constituent of stakeholder theory emphasized that effective management of dealings with key stakeholders can contribute to improve economic performance through the formation, improvement or preservation of ties that offers significant resources to businesses (Jones, 1995). An instrumental method to determine and manage the influences of crucial stakeholders on the firm can decrease costs by alleviating the possibility of adverse regulatory, legislative or fiscal action (Freeman, 1984; Hillman & Keim, 2001; Wicks et al., 1999). In addition, good relationship with stakeholder may attract, retain and motivate employees thereby increasing productivity and enhancing profitability (Moskowitz, 1972). Furthermore, a good stakeholder management can improves income by supporting efforts to distinguish the company's goods and services thus inviting socially sensible customers (Hillman & Keim, 2001), or invite economic resources from socially reactive investors (Kapstein, 2001; Boaventura et al., 2012). CSR through product quality and safety was found to improve customers' satisfaction which leads to patronage of firms products and services that improves sales or reduces cost (Waddock & Graves, 1997). Acting irresponsible was found to be leading to decrease in patronage, law suits or both which affect the bottom line (Berman, Wicks, Kotha, & Jones, 1999). SIC as defined by Barnett (2007) is "the ability of a firm to identify, act on and profit from an opportunity to improve stakeholder relationships through CSR". The stakeholders view firms differently depending on their fast relationship, therefore accord them different credibility, and reward them accordingly (Barnett et al., 2012). Based on the above arguments, the present study makes the following proposition:

P3 There is a positive relationship between stakeholder influence capacity and corporate financial performance

2.6 Mediating effect of stakeholder influence capacity on the relationship between corporate social responsibility and corporate financial performance

According to stakeholder theory, managing relationship with various stakeholder groups leads to a better corporate financial performance (CFP). According to Barnett and Solomon (2012), CSR and CFP are negatively related to some firms and positively related to others depending on how the firm is able to turn their CSR into valuable stakeholder relation. Barnett (2007) theorized that stakeholder influence capacity accrue as firms engaged in social responsibility practices. SIC was the capability of an organization to detect, act on and benefit from chance to increase stakeholder relationships through CSR (Barnett, 2007). Further argued that stakeholders view some firms as more credible than others and reward firms for their act of social responsibility accordingly based on their CSR history (Barnett & Solomon, 2012). The relationship between CSR and CFP is U shape due to the cost of social responsibility. However as firms apply more on CSR, they drained more resources, pending when the relationship neutralizes and turns positive as SIC accumulates from the increase CSR spending (Barnett & Solomon, 2012). Another explanation for the U shape could be the firms with poor CSR have the competitive advantage of not spending their resources on CSR therefore they would have favorable CFP than those with moderate CSR. However firm with high CSR have accrued adequate SIC stock considering their CSR history, therefore enjoying the benefit of that and reported the highest CFP. Firms with moderate CSR get the lowest CFP because they spend some moderate resources on CSR but not adequate enough to build SIC stock or not targeted to improve any stakeholder relationship, making the investment an agency loss, therefore not been able to turn CSR into CFP (Barnett & Solomon, 2012; Brammer & Millington, 2008). Many scholars opined that managing relationship with stakeholders help in improving CFP (Freeman, 1984; Jensen & Meckling, 1976; Jones, 1995;

Wicks et al., 1999). CSR leads to improve stakeholder relationship which accorded the firms some form of influence over the stakeholders. These influences will result in a smooth and cooperative relationship that will improve profitability or reduce cost (Barnett, 2007). Therefore building on this notion, the present study argued that SIC is an intermediary between CSR and CFP. Therefore the following proposition is formulated:

P4 Stakeholder influence capacity mediates the relationship between corporate social responsibility and corporate financial performance

3. Proposed research framework

Based on the reviewed literature the influence of CSR on CFP depends on the ability of the firm to convert CSR into SIC (Barnett & Solomon, 2012). The present study argued that the CSR investment that creates stock of SIC generate profitability as explained due to the stakeholder management, therefore the stakeholders tend to pay back in their various dealings with the firm and that leads the firm to a competitive advantage. Furthermore CSR investments that do not create SIC will not generate any return from CSR and the investment would lead to agency loss. Drawing on this, SIC serves as a mediator between CSR and CFP. Barnett and Solomon (2012) suggested that SIC can mediate the relationship between CSR and CFP. Consistent CSR activity that targeted at improving stakeholder relationship leads to the creation and accumulation of SIC, which later on leads to successful CFP. The proposed framework consists of three variables: CSR, SIC and CFP.

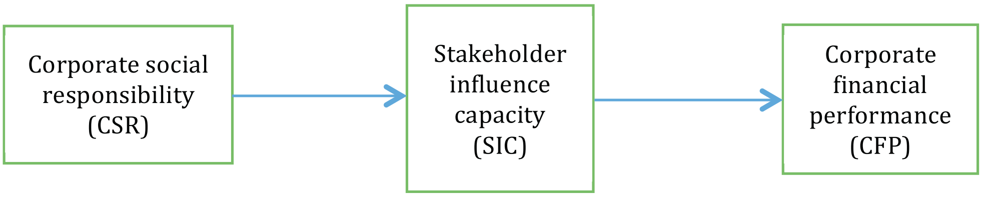

Fig. 1. Research Conceptual Framework.

4 Conclusion

In conclusion, this study is based on an on-going project. The main point is that firms should aimed at building stock of stakeholder influence capacity (SIC) in the course of discharging their corporate social responsibility (CSR) going by the improvements they will earn in their corporate financial performance (CFP). Meanwhile, the study has provides a conceptual framework that proposes the mediation effect of SIC on CSR-CFP relationship. Understanding the process through which CSR leads to CFP will provide a better understanding of the relationship will guide the management on CSR investment and will encourage them to take part in CSR. Finally, if the proposed framework is validated, the findings will provide significant contribution to the literature, managers and practitioners in making a better decision.

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