

The mediating effect of financial performance on the relationship between social responsibility and ownership structure

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Abstract

Existing literature is inconclusive about the relationship between social responsibility and institutional investors as it assumes, implicitly, that this relationship is direct. An alternative perspective, that has received less attention in the literature, is that this relationship can be mediated by other contextual variables such as financial performance. Thus, this study is aiming to provide some empirical evidence on this issue that may help in explaining divergence in prior work. Panel data regression was performed on a sample that includes all firms that are listed in the Egyptian social responsibility index during the period from 2007 to 2010. The results demonstrate that better (or worse) financial performance, and rather social responsibility, is the lead for institutional investors when they make their investment decisions.

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1. Introduction

The possibility that firms can develop a competitive edge over rivals by investing in social responsibility has been made increasingly likely over recent years by changes in investors' behavior and attitudes towards the society (Graves & Waddock, 1994; Saleh, Zulkifli, & Muhamad, 2010; Wahba, 2008b; Wahba & Elsayed, 2014a). As such, the concept of corporate social responsibility (CSR) is ever more on the agenda of business organizations. Despite literature suggests different definitions of CSR, generally, it refers to “the firm's consideration of and response to issues beyond the narrow economic, technical and legal requirements of the firm to accomplish social benefits along with the traditional economic gains which the firm seeks” (Davis, 1973, p. 313).

Change in corporate ownership structure with an increase in the stakes of institutional investors such as banks, mutual funds, insurance companies and pension funds (Sundaramurthy, Rhoades, & Rechner, 2005) has motivated

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many scholars to investigate the relationship between social responsibility and institutional investors. In this context, prior work has presented two contested perspectives. The first perspective argues for a positive relationship between social responsibility and institutional investors. The underlying premise of this argument is that since institutional investors are risk-averse (Mahoney & Roberts, 2007), and firm's reputation in social and environmental responsibility reduces stocks' volatilities (Petersen & Vredenburg, 2009), firms that invest in social programs and initiatives will be able to attract more institutional investors (Graves & Waddock, 1994). The other perspective argues for a negative relationship between social responsibility and institutional investors on the basis that social responsibility orientation does not match with institutional investors' investment horizon. In other words, because investing in social responsibility programs and initiatives is likely to lead to considerable costs in the short term (Hart & Ahuja, 1996) and the market often responds to social responsibility initiatives in the long-term (Shank, Manullang, & Hill, 2005), institutional investors are less likely to prefer socially responsible firms. This is because short-term performance cycles discourage them from supporting long-term projects as institutional investors mainly prefer near-term earnings (Bushee, 2001; Koh, 2003). In a similar vein, empirical studies that have examined the relationship between social responsibility and institutional investors offer inconclusive evidence (Coffey & Fryxell, 1991; Cox, Brammer, & Millington, 2004; Graves & Waddock, 1994; Mahoney & Roberts, 2007; Saleh et al., 2010; Wahba, 2008b, 2010).

Indeed, existing literature can be challenged due to its implied and simplest conjecture that the relationship between social responsibility and institutional investors is a direct relationship. Opposing and mixed findings in prior studies may be traced back to the fact that this relationship is not a direct relationship. Rather, this relationship can be mediated by other contextual variables such as financial performance, a point that has received less attention in literature. Specifically, the main argument in this paper is that better (or worse) financial performance, and rather social responsibility, may, in turn, be the guide for institutional investors when they make their investment decisions. This is because, “while the emergence of social criteria may influence institutional investment activity, these criteria probably remain subordinate to economic criteria” (Coffey & Fryxell, 1991, p. 439). For instance, although many investors value social responsibility, financial performance is still their main concern (Matterson, 2000). Moreover, not only financial returns are important for ethical investors (Sparkes, 1998), but also institutional investors do not consider social responsibility data unless they are presented in a “financial form” (Teoh & Shiu, 1990).

Thus, this study is designed to add to corporate finance as well as social responsibility literature in two ways. It seeks to explain the divergence in existing literature by examining the mediating effect of financial performance on the relationship between social responsibility and institutional investors. Moreover, it adds to our understanding by conducting research on a sample of firms from Egypt as a developing country, where much of the existing evidence reflects the context of developed countries. Presenting evidence from other less developed countries assists in developing existing theories of corporate finance as well as corporate social responsibility, as it may not be applicable to generalize conclusions from prior studies on other organizations that work in different cultures (Elsayed & Wahba, 2013).

The rest of this paper is structured as follows. The second section is devoted to presenting existing theoretical and empirical evidence regarding the relationship between social responsibility and institutional investors. Hypothesis development is introduced in the third section. Sample and variables measurement is presented in the fourth section. Econometric analysis is found in the fifth section. The final section is designated to introduce conclusion and implications of the main findings.

2. Social responsibility and institutional investors

Undoubtedly, the past few decades have witnessed a noticeable change in corporate ownership structure with an increase in the stakes of institutional investors such as banks, mutual funds, insurance companies and pension funds (Sundaramurthy et al., 2005). Institutional investors, according to the risk aversion theory, are rational investors who search for efficient investment by taking into account risk and return that associated with any proposed investment. Thus, they may consider corporate social initiatives and programs as a means to reduce potential risk (Wahba, 2008b). This is likely to occur as reputation in social and environmental activities may lower stock volatilities (Petersen & Vredenburg, 2009). Therefore, the net impact of social responsibility on institutional ownership, according to this perspective, is expected to be positive. In other words, firms that invest more in building its social reputation will be able to attract more institutional investors (Wahba, 2010; Wahba & Elsayed, 2014a). Conversely, institutional investors, according to the theory of myopic institutions (Hansen & Hill, 1991), are considered as

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