Social Network and Corporate Financial Performance: Conceptual Framework of Board Composition and Corporate Social Responsibility

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Abstract

Although a number of theories propose the relationship among corporate governance, corporate social responsibility (CSR) and corporate financial performance (CFP), existing literature does not provide a consensus of the direction of that relationship, or proposes how to enlarge it social network to absorb external resources. The purpose of this paper is to conceptualize the relationship between the composition of the board and corporate social responsibility (CSR) in the creation and development of a social network in order to improve firms' financial performance.

Keywords: Social capital, Social network, Board composition, Corporate Social Responsibility

1. Introduction

This study explicitly considers how the differences in board composition and the level of corporate social responsibility (CSR) will affect companies' ability to create a high level of social network in order to provide a higher corporate financial performance. Prior research focuses exclusively on how prescribed governance changes may influence a firm by its increased independence of directors. However, little attention has been paid to how firms' implementation of the characteristics of board composition may be perceived by the public and, consequently, how those characteristics will affect firms' social performance to attract and retain a qualified social image. Given the significance of board composition and CSR in corporate decision-making, the relationship between a firm's social activities and its financial performance is an important topic.

The study extends work in the corporate financial performance area from both corporate governance and CSR perspectives by conceptualizing the connections among types of firms' board composition and specific CSR dimensions. In order to comprehend these relationships, this study develops a conceptual framework based on the procedure of a literature review. The use of such a procedure allows for the simultaneous synchronization of all of the relationships between components.

2. Conceptual Framework Development

The conceptual framework presented here based on the premise of the literature. Figure1 presents a framework of the hypothesized antecedents of corporate governance and CSR to be discussed.

2.1 Social Capital and Social Network

Social capital can be found in the network of partnerships formed by an organization, and it embraces relationships with customers as well as business, industry and community relations (Moon & Kym, 2006). Besides, social capital is a factor that may contribute to the ability of directors to provide quality monitoring and advice. Adler and Kwon (2002) define social capital as being "the goodwill available to individuals or groups". Its source lies in the structure and content of the actor's social relationship, which is an informal norm promoting co-operation between two or more individuals (Fukuyama, 2001). Social capital is generally seen to be embedded in the relationship between parties rather than in the parties themselves (Adler & Kwon, 2002). That is, it is jointly owned by the organization and its members, and both parties benefit extrinsically and/or intrinsically from its existence (Leana & van Buren, 1999). Research shows that social networks may give actors access to abundant information, which leads to greater innovation (Burt, 1987; Powell et al., 1996). Social capital may also give an individual/organization power and influence in the eyes of external stakeholders. Therefore, having a board comprised of members with higher levels of social capital is likely to lead to improving firms' market performance. Consequently, a history of positive experiences by individuals and organizations with their partnerships is a likely contributor to relational capital, and this can be better understood by examining the sources of social capital (Adler & Kwon, 2002).

Social capital does not only rest in individuals (in the form of human capital) but also in the social network. Leana and van Buren (1999) define organizational social capital as being ‘‘a resource reflecting the character of social relations within the firm . . . realized through members’ levels of collective goal orientation and shared trust, which create value by facilitating successful collective action’’. Wagenaar (2004) provides an explanation of how the interaction of directors creates a shared understanding of what is appropriate in a particular situation, noting that this understanding is grounded in their shared organizational, social and cultural context. It seems that trust between two or more interdependent actors solidifies as a function of their cumulative interaction (Kramer, 1999) and therefore, those relations developed from individuals are valued and rewarded by means of experience over time. Additionally, Duysters and Lemmens (2003) further note that, when confronted by a new environment, organizations are more likely to look to existing partners rather than seeking new ones, since there are lower costs in investing in these relationships, and also less relational risk associated with the familiar. Therefore, the following is proposed:

Proposition 1: The personal relationships of directors will be positively associated with firms’ market performance because they indicate personal abilities to achieve effective organizational performance through linkages to the external environment.

2.2 Board Composition and Size

The majority of past research studied the linkages among board composition, leadership structure and corporate financial performance (CFP), concentrating on a particular aspect of governance, such as size, compensation, anti-takeover provisions, shareholders’ activism, investors’ protection, and so on. Berle and Means (1932) found a relationship between ownership and management toward CFP, and argued that CFP is increased when management is separated from ownership. The reason for this is that external directors are more professional, and are in a better position to exert control over management. Therefore, according to the Agency theory, effective boards will be comprised of external directors, since non-management directors are believed to provide superior performance benefits to the firm as a result of their independence from the firm’s management. This position is supported by some empirical results. For example, Ezzamel and Watson (1993) found that outside directors were positively associated with profitability among a sample of U.K. firms, and in an examination of 266 U.S. corporations, Baysinger and Butler (1985) found that firms with more external board members realized higher returns on equity. Fama (1980) maintains that independent directors are better at managing and monitoring management self interest and opportunism, and several other researchers have also noted a positive relationship between external director representation and CFP (Pearce & Zahra, 1992; Rosenstein & Wyatt, 1990; Schellenger, Wood, & Tashakori, 1989).

An alternative perspective would suggest a reliance on a preponderance of internal directors, and the Stewardship theory argues that managers are inherently trustworthy and not prone to misappropriating corporate resources (Donaldson, 1990; Donaldson & Davis, 1991, 1994). Quite contrary to the Agency theory, the Stewardship theory suggests that control be centralized in the hands of the firm’s managers (see Davis, Schoorman, & Donaldson, 1997, for an excellent review of the points of convergence and divergence between the Agency theory and the Stewardship theory). Ownership concentration can influence CFP (Shleifer & Vishny, 1997) because internal directors generally have a greater understanding of the company’s operations (Lang et. al., 1999). In addition, there is a stream of research which has found no relationship between board composition and CFP (Chaganti, Mahajan, & Sharma, 1985; Daily & Dalton, 1992, 1993; Kesner, Victor, & Lamont, 1986; Schmidt, 1975; Zahra & Stanton, 1988). This overview demonstrates that there is little consistency in research findings for board composition and CFP. Therefore, the following is proposed:

Proposition 2: Board composition will be positively/negatively associated with firms’ financial performance because higher external/internal directors provide firms with linkages to the external environment through which the firm can gain more information, resource and legitimacy than others.

The Resource Dependence theory is the primary foundation for the perspective that larger boards will be associated with higher levels of firms’ performance. In this perception, the board’s size may be a measure of an organization's ability to form environmental links to some critical resources (Birnbaum, 1884; Booth & Deli, 1996; Goodstein et al., 1994). According to Pfeffer and Salancik (1978), "The greater the need for effective external linkage, the larger the board should be". The board’s size was associated with a firm's ability to extract critical resources (Pfeffer, 1972, 1973; Provan, 1980), which may indicate that larger boards provide more possibilities for such interaction. However, researchers have not achieved a consensus of the idea that larger boards are associated with better performance. Jensen (1993) suggests that “When boards get beyond seven or eight people they are less likely to function effectively", and this view is consistent with that of Firstenberg and Malkiel (1994), who argue that a board with eight or fewer members "engenders greater focus, participation, and genuine interaction and debate". Group cohesiveness is another construct which may be applied to boards of directors. Cohesiveness, which may be facilitated by having fewer group members, has been related to CFP, and this idea is consistent with the more general view that larger boards may be less participative, less cohesive, and less able to reach consensus. For example, Judge and Zeithaml (1992) report that larger boards are less likely to become involved in strategic decision-making, and Goodstein and colleagues (1994) report that board size inhibits strategic change through reorganization. Yermack (1996) demonstrates that board smallness is associated with higher market evaluations, as well as higher returns on assets (ROA) and returns on sales (ROS). He concludes that whatever benefits may be associated with the largeness of the board may be overwhelmed by poor communication and decision-making processes. Therefore, the following is proposed:

Proposition 3: The board's size will be positively/negatively associated with a firm's financial performance because a larger/smaller board provides firms' with linkages to external/internal directors who can gain more information, resource and legitimacy than others.

2.3 Corporate Social Responsibility

Firms face a trade-off between social responsibility and financial performance due to increased costs from socially responsible actions which place them at an economic disadvantage compared to other firms with less social responsibility (Aupperle, Carroll & Hatfield, 1985; Ullmann, 1985; Vance, 1975). A contrasting view is that the explicit costs of corporate social responsibility are minimal, and that firms may actually benefit from socially responsible actions in terms of employee morale and productivity (Moskowitz, 1972; Parket & Eibert, 1975; Soloman & Hansen, 1985) and the cost of such actions may be offset by a reduction in other costs. The reason for increasing perceived social responsibility is to improve a firm's social image and permit it to exchange higher costs for less charges, since the value of a firm depends, not only on the cost of explicit claims, but also of implicit claims (Cornell & Shapiro, 1987). Furthermore, high CSR may improve a firm's access to sources of capital from abroad, and also progress its market performance. Although CSR may burden firms with heavy costs, they will experience relatively low operating risk as a result of more stable relations with social communities, as well as having a higher financial performance (Cornell & Shapiro, 1987). CSR may also be linked to firms' past financial performance. Firms with a relatively high past financial performance may be more willing to absorb these costs in the future (Parket & Eibert, 1975; Ullmann, 1985).

Several CSR-related research questions have been investigated, and the results may be attributed to the various ways in which the CSR construct has been operationally defined (Carroll, 1991). This study adopts a database developed by Kinder, Lydenberg, Domini, and Company (KLD), which objectively rates firms on nine dimensions of CSR, which may rectify the above problems. Five of the KLD dimensions have been frequently used for research purposes (Graves & Waddock, 1994; Turban & Greening, 1997), including a firm's social performance with regard to local communities, women and minorities, employee relations, the natural environment, and the quality of products or services. As Graves & Waddock (1994) mention, using KLD as a measure of CSR has several advantages. For example, KLD rates firms with an objective set of screening criteria, applies the ratings consistently across companies, and has a staff of knowledgeable individuals who are not affiliated with any of the rated companies (Graves & Waddock, 1994; Turban & Greening, 1997). Therefore, the following is proposed:

Proposition 4: When there are powerful social relationships in a firm, CSR will increase as a determination of the firm's financial performance.

Synthesizing the above discussion, the conceptual framework (Figure 1) suggests a research agenda with various research themes and questions.

3. Conclusion

In summary, when given the opportunity to engage with external directors in a social network, the experience of these changes can produce higher social capital and subsequently enhance corporate financial performance, and there is a willingness and ability to engage constructively with outsiders. Furthermore, the concept of CSR is a dynamic process aligned to a perspective of competitive advantage (Shetty, 1979) and is considered to be a strategic investment with potential long-term sustainable advantages. With an improved understanding of the processes by which kinds of governance and CSR variables contribute to market performance, firms will be better equipped to select, plan for, and manage the experiences which individuals and groups are exposed to, and plot the strategic trajectory that the organization should follow to ensure that its competitiveness is sustained.

The primary motive for this study is to encourage future researchers to more deeply investigate different board compositions, and their different effects on the specific dimensions of SC, the relevance of CSR to the SC dimensions, the coinstantaneous influence between governance and CSR, and the appropriate use for improving financial performance. The paper adopts a limited range of theoretical perspectives to explore the relationship among corporate governance, CSR, social capital and social network, and it recommends that alternative theories are needed for further investigation. Besides the conceptual deliberation, it is hoped that this paper has also laid a foundation for fruitful empirically-based research endeavors.

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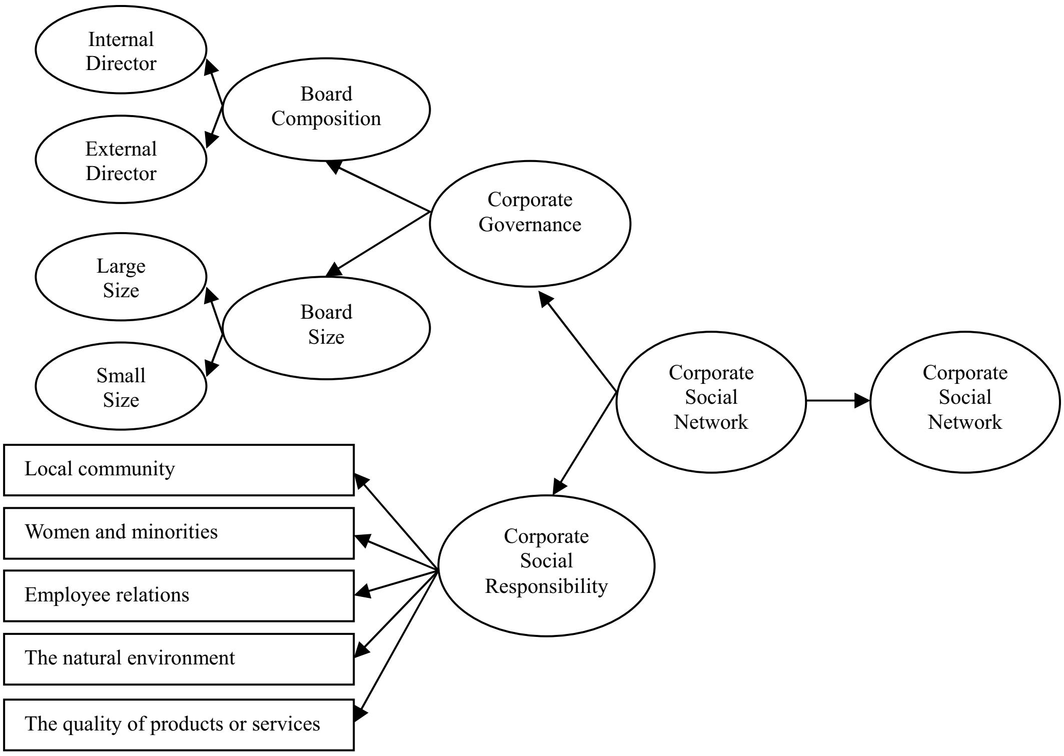

Figure 1. The conceptual framework of corporate governance, CSR, corporate social network and CFP