

Role of Customers in Stakeholders' Approach in Company Corporate Governance

Kolis Karel, Kubicek Ales

Abstract—The purpose of this paper is to explore the relationship between the customers' issues in company corporate governance and the financial performance. At the beginning theoretical background consisting stakeholder theory and corporate governance is presented. On this theoretical background, the empirical research is built, collecting data of 60 Czech joint stock companies' boards considering their relationships with customers. Correlation analysis and multivariate regression analysis were employed to test the sample on two hypotheses. The weak positive correlation between stakeholder approach and the company size was identified. But both hypotheses were not supported, because there was no significant relation of independent variables to financial performance.

Keywords—customers, stakeholder theory, corporate governance, financial performance

I. INTRODUCTION

THE purpose of this paper is to explore the relationship between the customers' issues in company corporate governance and the financial performance. The concept is based on the previous research of the instrumental stakeholder theory. However, we focus on the customers as one of the primary stakeholder group.

The main reason to analyze the role of customers from the corporate governance point of view is the fact that the prior empirical evidence indicated that the treatment of customers can have significant impact on financial performance (e.g. [1], [2]). The customers as the only one of the stakeholder groups generate revenue and therefore a company should include customer into strategy. The board as the governing body responsible mainly for developing and overseeing the organization's strategy is the ideal body to address this issue.

II. BACKGROUND

A. Stakeholder Theory

The idea of the stakeholder theory began back in the 1960s, but the first discussion about the stakeholder influence on firms was started by Freeman in 1984 in his now classic book where he defines: "A Stakeholder in an organization is any group or individual who can affect or is affected by the achievement of the organization's objectives" [3].

A series of books and articles discussing stakeholder approach follows and expands the existing theory.

Donaldson and Preston [4] points out that various authors approach the topic from different angles and often use contradictory arguments, and so they classify the three aspects of stakeholder theory as descriptive/empirical, normative, and instrumental.

From the normative point of view which is based on the moral principles, the company should respect and fulfill the interests of all their stakeholders, not only shareholders, because all stakeholders are affected by the company's existence. A descriptive view is used to describe the specific corporate characteristics and behaviors.

And finally, the instrumental stakeholder theory is used to analyze possible links between stakeholder strategy and corporate performance. The corporate objectives are achieved by the appropriate approach to those stakeholders who are important for the company's success. Hill and Jones [5] states that stakeholders differ in terms of importance of their stake in the company, and power. Therefore, it is necessary to focus on the most important stakeholders.

Clarkson [6] further enriches the theory when he divides stakeholders into two main groups. A primary stakeholder group typically consists of shareholders, investors, employees, customers, suppliers, government, and communities. It is obvious that without the participation of any of these stakeholders the organization cannot survive as a going concern. A secondary stakeholder group is not directly related to the organization but it might affect or be affected by the organization. As an example, Clarkson names media and various interest groups who might significantly influence public opinion either in the advantage or disadvantage of the organization.

Many other authors suggest various definitions and classifications of stakeholders but this fundamental background is sufficient for our research.

B. Corporate Governance

Corporate governance is defined as: "Procedures and processes according to which an organization is directed and controlled." [7]. Governance in the organization is executed through the two predominant models. In the unitary board system the governing body is called the board of directors, in the two-tier system the governance is comprised of two separate boards, a supervisory board and a managing board which is the case of the Czech Republic.

The governing body does not deal with the daily operation of the organization because it is the management's task. Its role and responsibility is to set up the organization's strategic direction and oversee, monitor and control the management in the given direction. Based on this presumption, the board should actively participate in strategy formulation, because otherwise it is rather questionable whether the board control of the management is truly effective. Bart and Bontis [8] tests a relationship between board and management involvement with organizational mission in 339 large Canadian and US organizations. They conclude that the active board engagement in the development of the mission has an important role and impact on the organization's performance.

Ales Kubicek is with University of Economics, Prague-Czech Republic e-mail:ales.kubicek@vse.cz

Thomsen [9] analyses the impact of corporate governance structure on corporate values, which represent the organization's philosophies or principles. Their definition is in hands of the governing body and company owner. A study of 71 Danish firms explains that besides the ownership and board structure, the company's stakeholder identity and power also influence corporate values.

Therefore, according to stakeholder theory, stakeholder structure and importance should be analyzed before setting up a strategy, since certain stakeholder groups can contribute to the achievement of the company's objectives [10].

III. LITERATURE REVIEW

The literature addressing the role of stakeholders in corporate governance is limited and the research is carried out mainly on the top management level. This is rather surprising because in 1983 Freeman and Reed already recognized the board of directors as the central body within the organization which should take care of stakeholder issues as it is mentioned in section II. Background. Therefore, we reviewed the literature related to measuring corporate social financial performance.

In our research we approach stakeholder theory from the instrumental point of view which is characterized by distinguishing among stakeholder's importance to achieve the company's objectives. In empirical research the main company objective is commonly represented as financial performance.

Allouche and Laroche [11] offers a great summary of existing research in meta-analysis of 82 studies examining the relation between corporate social and financial performance from 1972 to 2003 overwhelmingly from the USA and UK. They conclude that CSP has a positive impact on financial performance.

Wood and Jones [12] in their review of the empirical literature discovered that a consistent correlation between corporate social and financial performance was found especially in customers who have a direct effect on profitability.

Berman et al. [2] tests the relationship between stakeholder management models and financial performance *on the sample* of top hundred firms in Fortune 500. They employ five key stakeholder relationships: employees, natural environment, diversity, customer/product safety, and community and ROA as financial performance measure in their models. Only employees and customers were found to directly affect the financial performance. The remaining three relationships did not exhibit statistically significant impacts on the company's performance, despite it being implied by the prior research [13] and [1].

Spitzeck and Hansen [14] examines 46 firms, which exercise stakeholder engagement mechanisms, and explore how stakeholders influence corporate decision making. They identify operational, managerial, and strategic issues in which companies engage stakeholders. There is predominantly a stakeholder group of customers that companies regard as partners at the strategic level of decision making.

In the Czech Republic, the stakeholder issues started to be addressed lately both in business and academic circles. A survey conducted by KPMG in 2004 [15] offers a valuable view to the business practice. Besides other things, the survey's purpose was also to clarify which information board members use in the decision making process and in monitoring the company management. At the same time, the second Czech version of the Corporate Governance Code based on the OECD Principles of Corporate Governance was published as a set of voluntary recommendations.

Theodor [16] under the Czech and Austrian joint research program on Corporate Governance analyses the expectations and objectives of different stakeholders with the purpose to create a quantitative measuring tool of their satisfaction. The data sample consisted of forty firms, but only half of the indicators were gathered.

Blažek and Částek [17] in the tradition of the instrumental stakeholder theory examines stakeholder approach as a potential tool of firm competitiveness. Top managers from 432 companies were asked how they assess the importance of each of stakeholders' groups. The relationship between the stakeholder approach and financial performance was proved but statistically weak. A stronger effect was found in larger companies and stock companies which is in accordance with the argumentation of Freeman and Reed [10]. The interesting result for our study is the fact that the customers' importance was not found to influence financial performance. According to authors, the possible reason is that customers were assessed by managers as highly important or important in 87% cases. Therefore, the difference between better and worse performing companies could not be measured.

IV. INDEPENDENT VARIABLES

After the presentation of theoretical background and the literature review of international and Czech empirical research it is evident that the governing body holds the dominant position in company strategic decision making process, and according to stakeholder theory the stakeholder issues should be considered in the company's strategy. The empirical evidence of the prior research implies that customers are the one of main stakeholders' groups that has a significant influence on the company's financial performance.

This study's objective is to analyze whether the customer orientation of the managing board has any influence on the financial performance.

In the process of evaluating the customer approach we cannot rely on databases such as Kinder, Lydenberg, Domini which measure corporate social responsibility in the form of social index and are commonly used as a reliable source for the examination of the link between social and financial performance in the U.S. [18].

Therefore, for the evaluation of the customer approach we establish two domains which fall within the competence of the governing bodies, and include the possibility of customer involvement. Both were measured on a five-point Likert scale (1 for lowest and 5 for highest).

Consequently, we evaluated the individual companies on the basis of their answers from a questionnaire and publicly disclosed information from the company websites and database Albertina and Magnus.

A. Board involvement in corporate strategy

The first dimension is board involvement in corporate strategy where we evaluate how the board gets involved in the strategic planning and monitoring the management following the given objectives. The highest score means that the board is actively involved in strategy planning and the organization has set the key performance indicators (financial and non-financial) as the tool of strategic monitoring employed also for the board decision making.

Hypothesis 1: The score of the board involvement in corporate strategy is positively correlated with financial performance.

B. Customer approach at board level

The second dimension is the perspective of the customer in stakeholder approach. The company is given the highest score if the code of conduct is publicly available and the customers are involved in the strategic decision making as the company partner. In line with the prior research, we assume that:

Hypothesis 2: The score of the customer approach at board level is positively correlated with financial performance.

V. CONTROL VARIABLES

In order to properly analyze the relationship between the two independent domains and the financial performance, it is necessary to involve the control variables which could significantly influence the dependent variable ROA.

A. Board Size

First variable represents the main board characteristic which is typically employed in order to examine the relationship between corporate governance and financial performance. The evidence concerning the influence of the board size on the financial performance is not unified. Reference [19] found a strong inverse association between the board size and the company value measured by Tobin's Q in a sample of the U.S. companies, and several authors confirmed this finding [20], [21]. On the other hand, there is an evidence that the size of the board of directors is positively correlated with the board size [22].

B. Company Size

The second variable is a commonly used company factor. Company size has an effect on financial performance and is monitored in most studies (e.g. [5] and [10]). As long as companies in the Czech Republic are mostly not listed, it is not possible to use market capitalization as a measure of the company size. For this reason the revenues were used as the most appropriate proxy. Since correlations aim to find linear relationships, the heavy skew in the distribution of revenues justify the use of the natural logarithm of this variable for analysis.

C. Number of customers

Since the data sample is not sufficient to employ the industry control variable, this variable separates companies according to number of customers into 3 groups: less than 10, 10 to 100, and more than 100 customers.

VI. DEPENDENT VARIABLE

Company performance is measured as the return on assets ratio (ROA) defined as earnings before interest and taxes (EBIT) divided by the book value of assets. ROA is an indicator of accounting-based measures which are generally criticized since they are based on historical data and so the results do not reflect an actual situation. For that reason, a majority of empirical studies also involve Tobin's Q as a dependent variable. Tobin's Q is a market-based measure of the company's performance related to its market value. However, this indicator is not applicable in the Czech Republic as the vast majority of the companies in the data sample are not listed on the Prague Stock Exchange.

VII. DATA SAMPLE

The questionnaire was sent to 500 joint-stock companies from different sectors, such as agriculture, industry and services, with more than 50 employees. This sample was selected from the Albertina database, and sent to the contact e-mail address of the companies. From 500 questionnaires sent, 60 companies (12%) answered. Response rate is similar to prior research inquiring members of governing body [23].

The data sample for an empirical investigation of corporate governance generally consists of listed companies. However, there are only 28 companies listed on the Prague Stock Exchange that would not be considered as a representative data sample. Nevertheless, there are no obligations related to corporate governance requested by the Prague Stock Exchange, and so it is fully in the competence of the companies whether they comply with good governance practices.

Additional information about the companies was added from Albertina (www.albertina.cz) database, Portal of Czech Ministry of justice (<http://portal.justice.cz>), and company websites.

VIII. EMPIRICAL RESULTS

On a simple correlation analysis (Table 1), there is no significant relationship between the analyzed variables (Score Strategy and Score Customers) and ROA. Neither there is any correlation between monitored variables (ROA, Revenues, Board Size and Number of Customers) or analyzed variables.

However, it is possible to see a weak correlation of 0,274 between Score Customers and revenues which is a proxy variable for the company size. That would imply that larger companies tend to address the customers from the view of stakeholder approach at board level on a larger scale. The second notable but still weak correlation of -0,249 is between monitored variables board size and ROA implying that the smaller boards are more efficient measured by ROA.

TABLE I
CORRELATION MATRIX

Variable	Mean	Std. Dev.	1	2	3	4	5	6
1 ROA	5,10%	5,66%	1					
2 Revenues (ln)	19,92	1,42	0,198	1				
3 Score Strategy	3,35	1,01	0,075	-0,043	1			
4 Score Customers	2,52	0,91	-0,037	0,274*	0,095	1		
5 Board Size	7,30	2,34	-0,249*	0,142	0,156	0,141	1	
6 Number of Cust.	0,73	0,45	-0,187	0,018	0,098	0,053	0,143	1

*. Correlation is significant at the 0.05 level (1-tailed).

TABLE II
MULTIVARIATE REGRESSION ON ROA

Dependent: ROA	β	Std. Error	t Stat	P-value
Constant	-0,114	0,103	-1,103	0,275
Revenue (ln)	0,011	0,005	2,053	0,045
Score Strategy	0,009	0,007	1,207	0,233
Score Customers	-0,005	0,008	-0,592	0,557
Board Size	-0,007	0,003	-2,151	0,036
Number of Cust.	-0,021	0,016	-1,299	0,200

In the next step, the multivariate regression analysis is performed with ROA as the dependent variable. Score Strategy and Score Customers are used as the independent variables and Board Size, Revenues, and Number of Customers as the control variables. The Adjusted R square of full model with five variables equals 0.09 which supports low values of beta coefficients and suggests that the independent variables do not describe the variability of ROA. Therefore, neither hypotheses were supported because neither of the two independent variables is significantly related to financial performance.

IX. CONCLUSION

Because of the lack of empirical studies concerning the stakeholder theory and corporate governance in the Czech Republic, one of this paper's objectives is to examine the customer orientation at the board level. The findings of this study do not support the hypotheses based on theoretical background as the model does not describe the variability of ROA. The empirical results presented in this paper are limited in several ways. The main problem is the small data sample consisted of 60 companies. That is slightly more than the minimum required sample size for the regression analysis but the power of a statistical test is rather lacking [24].

However, our company survey is still in progress and the sample is going to increase. That way, the industrial effects which were found to significantly influence the importance of each stakeholder groups may be employed in the analysis (e.g. [25], [2]). Another issue is the fact that ROA, commonly used as the dependent variable in the empirical studies from other countries, may not be the most suitable variable in the Czech Republic because of the irrelevance of the book value of assets in Czech companies.

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