

Capital Structure as a Mediating Factor between Uncertainty, CSR, Stakeholder Interest and Financial Performance

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Abstract

We examine the association between capital structure and its determinants (uncertainty, corporate social responsibility (CSR) and stakeholder interest) on financial performance. We also investigate the mediating role of capital structure between uncertainty, CSR, and stakeholder interest with financial performance. Chief Financial Officers (CFOs) of the service sector in Pakistan were surveyed using a closed-ended questionnaire. SEM was applied to get results. Our findings suggest that uncertainty, CSR and stakeholder interest have a significant impact on organizational financial performance and on capital structure. Further, capital structure appears to be a key mediator between uncertainty, CSR and stakeholder interest and financial performance. The results suggest that companies take initiatives in CSR activities and screen out uncertain situations while making financial decisions.

JEL: G20 & G32

Keywords: Capital structure, uncertainty, CSR, stakeholder interest, financial performance.

1. Introduction

Being forward-looking, financial decision-making involves a careful selection of financial management practices incorporating uncertainty as its major determinant. Major theoretical advances in financial decision-making have been made over the last few decades. However, recent theoretical models do not agree on the signs of the relation between financial management practices and uncertainty. Miller and Waller (2003), and Chatterjee et al. (2003) reveal that uncertainty influences the financial decisions adopted by finance executives. Capital structure has

a major impact on firm performance (Chowdhury & Chowdhury, 2010). Firms seek to minimize their financing cost whilst maximizing financial performance. Over the years, researchers have highlighted the importance of corporate strategy as a significant predictor of capital structure, with a firm's capital structure having a direct function within economic growth (Scherr & Hulburt, 2001).

We extend the existing body of knowledge by uncovering the rarely researched determinants of financial decisions: uncertainty, corporate social responsibility (CSR), and stakeholder interest. CSR is argued as improving firm performance by increasing competitive advantages and reducing the occurrence of stakeholders' compensation claims (Wood, 1991a). Some managers accept such a supposition; others reject this by suggesting that investment in CSR trades off with profitability (Devinney, 2009 and Friedman, 1970). Further, if the firm's initiatives with respect to CSR are not aligned with its core objectives, it can become a liability and can harm brand loyalty by affecting beliefs of customers about the firm. Researchers have focused on this matter by examining CSR's effects on profitability. However, the results of those examinations are mixed (Ntim & Soobaroyen, 2013).

Stakeholder interest has an important effect on corporate decision-making related to capital structure. Waddock and Graves (2000) find that visionary companies have performed very well throughout history. Stakeholders' interest regarding firm-specific investments significantly influences the financing decisions of the firm. Previous research highlights the company's relationship with its stakeholders' interest and financial decisions (Preston & Sapienza, 1990; Berman & Wicks, 1999). In spite of this, few empirical studies have examined stakeholders' interest in the perspective of the determinants of financial decisions.

Our study will allow a better understanding of the interaction between financing decisions of a business and intra-stakeholder relation. We make the recommendation that a firm's financial decision can be altered by its strategy regarding CSR. The direct relation of uncertainty, CSR, and stakeholder interest, organizational financial performance and financial decisions have been investigated in past literature (Hunjra Niazi, Akbar, & Rehman, 2011). For further identification of the problematic research area, the indigenous and international research studies related to the determinants of financial decisions and organizational financial performance are critically reviewed. Earlier literature has investigated the direct relation and impact of CSR, uncertainty, and stakeholder interest on organizational performance, but did not discuss or explore the mediating effect of capital structure. We will focus on the mediating role of capital structure on CSR, uncertainty, stakeholder interest and performance relationship.

In comparison to the rest of world, Pakistan is still in the process of proper implementation of financial decision policies. If financial decisions are not properly made, they may affect the value and profit maximization of firms. The organizations would achieve an optimal use of resources and gain maximum profit by implementing these practices on a different level of financial decisions, like capital structure.

The findings of our study are beneficial for capital providers/lenders and shareholders, due to applications of benchmarked financial decisions. When they believe their funds are being managed properly, they will invest more. On the other hand, capital providers will be hesitant to invest in firms that do not practice the proper financial decision-making techniques. This would also help the organization to attract more investors and hence increase its value. The findings are also helpful for market authorities and regulatory bodies. The fair disclosure of the organization and proper

information regarding the financial practices will help them to review and prepare financial and accounting regulations regarding the performance of firms. Similarly, the financial managers can acquire the capability to effectively forecast the industry structure and information by exercising best financial decision techniques. The results of the study will be of great importance for financial managers in efficiently devising their financing and investing decisions. It leads to a better understanding of a firm's status in the business world to set future objectives to compete in the market. This will result in raising revenues and contributing towards GDP. Our study will also be important for the government, regulatory bodies, and policy makers. The Security and Exchange Commission of Pakistan would be able to develop the rules for enhancing organizational performance. The increasing revenues will be contributing more towards the taxes collected by the government.

The rest of the paper is structured in five sections. Section 2 describes findings of past studies and hypotheses development; section 3 discusses the identification method, and the data and variables used for the empirical analysis. Section 4 discusses the empirical results. Section 5 offers recommendations and concludes the paper.

2. Hypotheses

The stability of high performing businesses is a result of choosing financial practices with the industry cycle events as well as flexibility and specialty. Tse (1991) suggests that businesses with high performance are more formalized, and specialized when compared to low performance business. In contrast, low performance businesses are more centralized when compared to high performance businesses. A strategic plan based on industry analyses through which managers investigate different factors arguably contributes greatly to the firm's success (Bernhardt, 1993).

The gap between available and required information to make financial decisions is known as uncertainty (Galbraith, 1973). Zimmermann (2000) argues that uncertainty concerns should be based on the quantity and quality of available information. Further, he argues that there is no model available that counters each and every aspect of uncertainty due to a lack of quality and quantity of available information. Boyle and Guthrie (2003) argue that it is necessary to separate the effect of payoff and financing uncertainty to consistently identify the nature of the uncertainty on investment. In the presence of financial constraints, firms face uncertainty not only with respect to the future return of the project, but also with respect to the ability to finance the investments. Baum et al. (2010) investigate the linkages between cash flow, investment behavior, and uncertainty. Uncertainty is considered three ways, derived from firms' stock returns, from the S&P 500 index returns, and a CAPM-based risk measure. For an estimation sample of 4,028 manufacturing firms from 1984 to 2003, they conclude that uncertainty is an important determinant of a firm's investment behavior, particularly through cash flow, changing as the uncertainty adjusts over time.

The large theoretical literature generally argues for a negative relation between investment and uncertainty (Bernanke, 1983; McDonald & Siegel, 1986; Ingersoll & Ross, 1992; Schwartz & Trigeorgis, 2004). Empirical research generally supports this contention (Leahy & Whited, 1996; Guiso & Parigi, 1999; Minton & Schrand, 1999; Bond & Cummins, 2004).

At an organizational level, there is the uncertainty of the owner about whether or not his firm will succeed; this is the manner by which business people normally comprehend uncertainty. Likewise, every firm will attempt to accomplish the task as well as expected under the uncertain conditions. Endeavors to this concern the control of assets, bringing about a smaller measure of asset uncertainty. Unfaithful clients, inconsistent suppliers, absence of funds, and crafty workers are all examples of asset uncertainty. On the individual level, instability about achievement is created by

the uncertainty of the business visionary about his own entrepreneurial limits (Jovanovic, 1982). Issues of self-efficacy have been well-researched by Bandura (1977). Finally, uncertainty can be considered at the information and knowledge level. Information uncertainty is deemed a meta-category of uncertainty, with all other forms of uncertainty influencing the level of information uncertainty (Von Gelderen et al., 2000). The literature shows that uncertainty affects firms' strategic decision. As the uncertainty increases, the costs for the firm become higher by adjustment of capital, like fluctuation in demand, variation in the stock prices, and volatility in political and economic factors (Jensen and Meckling, 1976). In an environment of high uncertainty, firms may present liquidity constraints, increasing the need of external capital, and raising the risk premium (Baum et al., 2010).

According to Van-Gelderen et al. (2000), each form of uncertainty arguably is differentially related to firm performance. On the one hand, resource uncertainty and a non-munificent environment can be expected to have a negative effect on firm performance. Resource uncertainty approximates being a win measure; it reflects the hold a firm has on resources, and firms can be relied upon to perform more poorly in a situation with numerous contenders in respect to restricted benefit and venture opportunities. Changing or complex markets, on the other hand, should not be more or less profitable than average, a priori. Knowledge uncertainty could be influenced by change and complexity on the one hand, and by performance on the other, as performance gives feedback on the value of the knowledge available (Miner et al., 1989). Keeping all this in view, we propose the following:

H1: Uncertainty negatively affects financial performance.

Jamali and Karam (2016) performed content analysis of 452 CSR articles for the period 1990–2015. Based on this comprehensive review, they identify five key attributes. First, complex institutional antecedents within the national business system (NBS); second, complex macro-level antecedents outside the NBS; third, the salience of multiple actors involved in formal and informal governance; fourth, hybridized and other nuanced forms of CSR expressions; and fifth, varied scope of developmental and detrimental CSR consequences. They conclude that CSR is invariably contextualized and locally shaped by multi-level factors and actors embedded within wider formal and informal governance systems.

There are two purposes of investment in CSR, one is legitimation (social/moral/relational) and the second one is efficiency (instrumental) (Aguilera et al., 2007). However, the literature argues that CSR may not be strongly associated with corporate financial performance (CFP). Firms which engaged in CSR practices in response, may lead to regulative, cognitive, and normative institutional forces in order to gain and improve corporate legitimacy. On the other side, when are highly committed to CSR to strategically enhance corporate efficiency, it is expected that CSR may impact CFP. Consistent with this conflicting set of theoretical perspectives, the considerable numbers of studies that have examined the CFP and CSR association report mixed results (Callado-Munoz and Ultrero-Gonzalez, 2011; Nelling and Webb, 2009).

There are two different perspective about the relation between CSR and CFP. Firms that invest more in CSR are bearing more costs and these may place them at an economic disadvantage as compare to less socially responsible firms (Friedman, 1970; McGuire et al., 1988). In contrast, engaging in CSR can enhance efficiency and CFP by reducing information asymmetry (Jensen & Meckling, 1976; Reverte, 2009). Greater commitment to CSR can improve CFP by facilitating conformance to social norms in order to legitimize corporate operations that may not only enhance

corporate reputation and image, but also provide access to critical resources (DiMaggio and Powell, 1983; Suchman, 1995). Addressing the needs of powerful stakeholders, such as customers, governments, and employees, may also enhance CFP by reducing political costs (litigation, regulation, taxation, and nationalization), labor frictions, and customer boycotts (Donaldson and Preston, 1995; Freeman, 1984). Based on all the arguments above, we propose the following:

H2: CSR positively affects financial performance.

Stakeholders of the firm are those people who are affected by the firm's operations if it is not in line with the firm's objectives (Freeman, 1984). Friedman and Miles (2006) state that a firm's management should consider itself as stakeholders, and all the operations of the firms should be according to interests, needs, and viewpoints of all the stakeholders. They should participate in decision-making and protect the rights of other stakeholders. Secondly, this stakeholder management must have a principal agent relationship with other stakeholders and work for the long-term survival of the firm.

The social impact hypothesis argues for a positive association of meeting the interests of all stakeholders and the firm's output in financial terms (Freeman, 1984). So, if all claims of stakeholders are considered it should lead to an increase in the firm's output in financial terms. Freeman (1984) notes that the foremost long-term objective of any firm was to create value at the stakeholder's end. The association of management and stakeholder has important effects on the firm's output in financial terms. The first important intention of managers should be to maintain a good environment in which all stakeholder's can deliver their skill and knowledge better to the firm (Freeman, Wicks, & Parnar, 2004). Firms who consider the interests and opinions of stakeholders have good output in financial terms in the upcoming future. If the firm has a positive

relation between management and stakeholder this increases the resource of stakeholders' interest and ultimately it will increase the overall performance of the organization. The interest and options of all stakeholders should be encountered in the decision-making done by management; if the firm fails to do this, it would lose investments made by these stakeholders (Lorca & Garcia-Diez, 2004). Therefore, to build a positive and effective network with all stakeholders concerned becomes a necessity for survival of firms (Post et al., 2002). Based on the discussion above, we propose the following:

H3: Stakeholder interest positively affects financial performance.

Capital structure decision is one of the major decisions in firms. It relates to the financing mix of the company and involves decisions on whether to use internal s (retained earnings) or external sources (debt v/s equity) sources of financing. According to the Modigliani Miller theorem, agency cost theory, static trade off theory and pecking order theory are key theories of capital structure. Ahmad et al. (2012) highlight the importance of decisions regarding capital structure as a wrong decision may have an adverse effect on performance. The pecking order theory is based on the concept of the use of internal funds of an organization. In order to gain a better understanding of the relationship between a firm's performance and capital structure decisions. Chowdhury and Chowdhury (2010), are of the view that firms add more capital to produce greater revenue. When the total capital of a company comprises only equity and no debt, then shareholders are entitled to all the earnings after tax. As firm adds debt to their capital structure, creditors also get a share of profits as a reward for the use of their funds. Experts in finance say that debt financing is profitable only up to a certain extent; afterwards, it may prove disadvantageous. However, there should be a favorable capital structure which may enhance the value of firm.

Eriotis et al. (2011) state that firms which raised financing from equity as compared to firms raising funds from debt source are more revenue generating. If debt ratio is high, then some of the profit simply evaporated in the form of interest payment made to external stakeholder. Therefore, capital structure choice has vital role in the enhancement of firm performance. Cai and Zhang (2006) state that firms which are highly leveraged have low profits. Highly leverage negatively affects the firm performance. According to the pecking order theory, more debt usage by a firm reduces a firm's future debt-taking ability and firm's investment goes down. The trade-off model proved that if firms used debt beyond a limit, it negatively affected their performance. Therefore, the high levered firm negatively affect the firm performance.

Imran (2012) analyzes the association between firm's performance, equity ownership and capital structure. Several firms use debt as a controlling agent, as an external stakeholder keeps better check on the management's decision regarding firm's operation to generate the profit. The organizations with high leverage generates more profit than the firms which use their extra cash. Capital structure is definitely among major factors that influence the firm performance. As there are bankruptcy costs, further use of debt leads to deteriorating returns for tax deduction benefits. Therefore, bankruptcy costs rise at a higher rate than the marginal tax saving benefits related to the additional replacement of debt for equity beyond an appropriate capital structure. Firms prefer minimizing their financing cost while maximizing performance; minimizing their financing cost through stabilizing the proper capital structure, more correctly termed optimal capital structure. According to the view of Harris and Raviv (1991), for both the manager and the shareholders the capital structure is something which is associated with the trade-offs between the liquidation cost and liquidation gain. Thus, it can be concluded that firms may be having a greater portion of debt in the capital structure than is appropriate to acquire greater advantages for shareholders as well

as managers. Harris and Raviv (1991) explained the reason as being more debt in capital structure including, at the time of winding up, not giving importance to bankruptcy cost and the managers and shareholder coinciding concerns.

Leland and Pyle (1977) are of the view that because high leverage implies higher costs of bankruptcy and risk for lesser quality firms, administrators would be taking the debt to equity ratio as a signal. As managers do have the advantage of information compared to outsiders, the structure of debt may act as a market signal. Modigliani and Miller (1963), in their second decisive paper on capital structure, that the firm value as an increasing function of leverage based on tax deductibility of payments of interest available at firm level. Extensive academic effort has been invested in the 30 years after the MM second paper for recognizing the costs connected with debt financing that companies most probably trade off in reaction to this significant tax advantage. Though direct costs of bankruptcy are perhaps small, yet potentially vital aspects include asymmetric information, personal tax, corporate control, input/product market exchanges, and agency cost concerns. Reviews of related studies include Harris and Raviv (1991), Bradley et al. (1984), and Masulis (1988). Early empirical findings on trade-off theory (Bradley et al., 1984) provide mixed outcomes. On the other hand, studies investigating the response of the capital structure to variations in tax exposure (Mackie-Mason, 1990; Givoly et al., 1992) present confirmation in support of the trade-off theory. Myers (1984) argue that trade-off theory also remains unsuccessful in predicting the wide degree of time variation and cross-sectional behavior of debt ratios under observation. Any announcement of issuer exchange offers leads to an increase in stock return. As a whole, almost 55 percent of the variation in returns in a stock announcement period qualifies as explained (Masulis, 1983).

Ross (1977) and Leland and Pyle (1977) state that debt/equity ratio will be taken by managers as a signal based on the fact that by high leverage is meant a greater risk of bankruptcy (and cost) for those firms of lesser sophistication. As managers are, on the basis of greater information, in an advantageous position over the outsiders, it could be thought that the structure of the debt may be assumed as a signal to the market. It is suggested by Ross's model that the firm value will rise because of leverage, because leverage increase leads to increase in the market's perception of value. Supposing that there is no existing agency related problem, and that the management performs the best interest of shareholders; company value will be maximized by ensuring the optimal capital structure, thus leading to a highest possible debt ratio. Firms of higher quality have to give a signal to the market of their quality while the managers of comparatively lesser quality firms may be trying to copy the decisions. Based on this argument, the level of debt should have a positive relation to firm value. Myers and Majluf (1984) argue in pecking order theory, in connection with asymmetry of information, that a firm adopts a strategy that leads it towards the pecking order in the hunt for the ideal financing mix. The argument informing this theory is that the managers, though, have to act on the behalf of managers, but it is observed that they will issue the securities at a higher price compared to their intrinsic value. The trade-off theory postulates that firm which is safe means they have more tangible assets and more taxable income to shield prefer high portion of debt whereas risky firms are dependent on the equity financing. As per this theory, higher profitable firms are those which have more capacity to serve and utilize the debt portion in their capital structure and get the benefit of the tax shield. This is why such firms need to be incorporating a higher debt in their capital structure. Based on all the discussion above, we propose the following:

H4: Capital structure positively affects financial performance.

Boyle and Guthrie (2003) argue that it is necessary to separate the effect of payoff and financing uncertainty to identify consistently the nature of the uncertainty on investment. For the authors, in the presence of financial constraints, firms face uncertainty not only with respect to the future return of the project, but also with respect their ability to finance investments. Eisdorfer (2008) develop a model of investment under uncertainty for financially distressed firms. The model is based on the notion that financially distressed firms are able to shift losses to debt holders. Therefore, the model predicts that the financially distressed firm has a greater incentive to invest when uncertainty is higher because the losses associated with bad outcomes are borne by the debt holders while shareholders enjoy the gains associated with better outcomes. In other words, since higher levels of uncertainty raise the likelihood that new investments are highly profitable, and since shareholders reap the rewards if things go well, but do not bear the costs if things go badly, the asset substitution problem (Galai & Masulis, 1976; Jensen & Meckling, 1976) state that distressed firms with an incentive to engage in higher levels of investment when uncertainty is higher.

In the literature, determinants of capital structure are widely discussed. Modigliani and Miller (1958) argued that finance and the real decisions are important, hence, under perfect capital market assumptions, a firm's market value and investment plan are independent of its capital structure or the debt scheme. However, recent studies provide some evidence contrary to this. Fazzari, Hubbard and Petersen (1988) argue the leverage of the company depends on the specific characteristics of the company's cash holding, total assets, investment to capital ratios (Shuetrim, Lowe & Morling, 1993; Auerbach, 1985; Weill, 2001). In addition, the macroeconomic uncertainty empirical evidence of interaction between indicators and capital structure was quite scarce. Baum et al. (2006) find that macroeconomic uncertainty and cash to assets ratio was inversely correlated for

U.S. non-financial corporations, which supports the view that macroeconomic uncertainty is an important factor in a company's decision about capital structure. Based on all discussion above, we propose that:

H5: Uncertainty negatively affects capital structure.

H6: Uncertainty and financial performance are mediated by capital structure.

The theory of stakeholders put forward in 1980s for the explanation of the association of the firm with other stakeholders within two dimensions, legal (definite compliance with certain stakeholders), and economic (implicit compliance) (Freeman & Reed, 1983). A research study on the social responsibility of firms (CSR) shows that some societies answered this concern by dedicating more means to CSR. By considering it a competitive advantage, CSR can be considered as the strategy of firms in order to gain a good reputation within the market (Maignan & Ferrell, 2001; Drumwright, 1994). However, in some companies, the administration resisted, arguing that the additional investment CSR was inconsistent with efforts to maximize benefits. The social welfare and sustainability of a company are the key subjects of study and research for the issue of social responsibility nowadays.

Social responsibility can be defined as the moral duty of a society to protect and nourish the social wellbeing today and in forthcoming days. This can be done only by taking care of the long-term impact of every decision in favor of all stakeholders, especially society (Hay et al., 1976). Very few studies examine the link between CSR performance and capital structure. The most important work in this area of research is undoubtedly that of Girerd-Potin et al. (2011). Their model is in line with the trade-off theory of capital structure. They develop a financial management model, in which the optimal capital structure is determined by the trade-off between costs (bankruptcy costs)

and benefits of the debt (tax gains) on the one hand, and the costs and benefits of equity on the other. Based on the assumption that socially responsible firms have a lower cost of equity than socially irresponsible ones, the benefits and costs of issuing equity include a penalty (or premium) for social irresponsibility (or responsibility). Girerd-Potin et al. (2011) assume in their model that companies can choose their level of CSR investment freely, that banks are not sensitive to CSR performance, and finally, that investors seek to maximize their utility function, which depends both on their wealth and on CSR performance of firms in which they invest. The main conclusion of this model is that CSR performance determines, to some extent, the financial structure of firms. Socially responsible companies will be more likely to issue more equity than their socially irresponsible counterparts, to benefit from the reduction of their cost of equity.

Recently, two studies have focused on the link between human capital investments (CSR) and financing decisions (Verwijmeren & Derwall, 2010; Bae et al., 2011). These works are related to several theoretical models that analyze the impact of relations with non-financial stakeholders like workers, suppliers, or customers on capital structure (Maksimovic & Titman, 1991). Orlitzky et al. (2003) confirm the relation between CSR and corporate debt. Observing the relation between environmental performance and cost of capital, Sharfman (1996) and Fernando (2008) note that companies having good environmental performance in the face of higher bond yields also have a higher debt to equity ratio. They suggest that there is easier access to debt financing for responsible business with greater debt capacity. Chen et al. (2007) project that unionized firms have lower cost of debt compared to non-union companies because the unions show a lesser trend for shareholders to deprive bondholders because of union pressure.

The corporate debt market is a good arena to find a connection between social performance and financial performance, because of the intermediary role played by banks in this regard. The main

benefit of utilizing the debt market is because of its information efficiency. Altman (1968) observe that the syndicated loan market information is more efficient than the bond market while the loan market discovers information about default before the bond market. Allen et al. (2008) report that negative earnings announcement is expected by the loan market and is shown in the stock market. The company's capital structure may also affect the conflict of CSR. Firms will have to pay higher interest rates, which limits their capability of the insiders to over-investment in CSR. This is similar to the argument by the Jensen (1986) and Zweibel (1996). A more participative and monitoring role is played by the high debt levels also being added to the creditors (Diamond, 1991; Gilson, 1990) that helps to minimize the risk. Based on all the discussion above, we proposes that:

H7: CSR positively affects capital structure.

H8: CSR and financial performance are mediated by capital structure.

Titman (1984) indicates for the first time that stakeholders' interest regarding firm-specific investments significantly influences the financing decisions of the firm. The financial condition of the firm is important while making firm-specific investment since the stakeholders have to face the switching costs if somehow the firm is liquidated. Switching costs of the stakeholders are related to the firm's assets or products. The firms try to reduce the liquidation risk by maintaining the lower leverage and hence providing better incentives to the stakeholders. Studies reveal that the firms that maintain good and bilateral supplier and customer relationships tend to maintain a low level of leverage. The relationships also influence the financial management practices of the firm, so that better incentive is given to the stakeholders (Titman & Wessels, 1988; Banerjee, Dasgupta, & Kim, 2008; Kale & Shahrur, 2007). Barton et al. (1989) test the association of shareholders and capital structure, by categorizing firms into eight groups in terms of high and low

net organizational capital. They find that high net organizational capital firms are financed more by equity when compared to low net organizational capital. Titman (1984) argues that firm specific investments made by stakeholder interest depend upon the liquidation possibility. He further argues that stakeholders have to bear the switching cost at time of liquidation, so the financial conditions of the firms had great influence on investment behavior of stakeholders. On liquidation of firm, switching cost is positively related to the uniqueness of an asset, so the firms that have unique assets have a low chance to liquidate.

Literature shows that stakeholders have a great impact on the business strategies (Banerjee et al., 2008), compensation plans for CEO (Arora & Alam, 2005) and firms' earning management (Raman & Shahrur, 2008). Titman (1984) develops a theoretical work on firm's stock market performance and capital structure. Kale and Shahrur (2007) and Banerjee et al. (2008) find a negative and significant relationship between customer and supplier on firms' leverage ratio. There is an association between the leverage ratio and the employees of the firms, because their relation specific assets would be less valued at the time of liquidation. When employees find a new job, or when it becomes more difficult for employees to use their skills and knowledge, losses to firms would be higher in terms of human capital. However, while making financial decisions (capital structure, dividend policy & capital budgeting), managers must formulate and implement processes which satisfy all and only those groups who have a stake in the business. The main task in this regard is to manage and integrate the relationships and interests of shareholders, employees, customers, suppliers, communities and other groups in a way that guarantees the long-term success of the firm. Management should be actively concerned with the interest of stakeholder in order to make the financial decisions. Based on the discussion above, we propose the following:

H9: Stakeholders interest positively affects capital structure.

H10: Stakeholders interest and financial performance are mediated by capital structure.

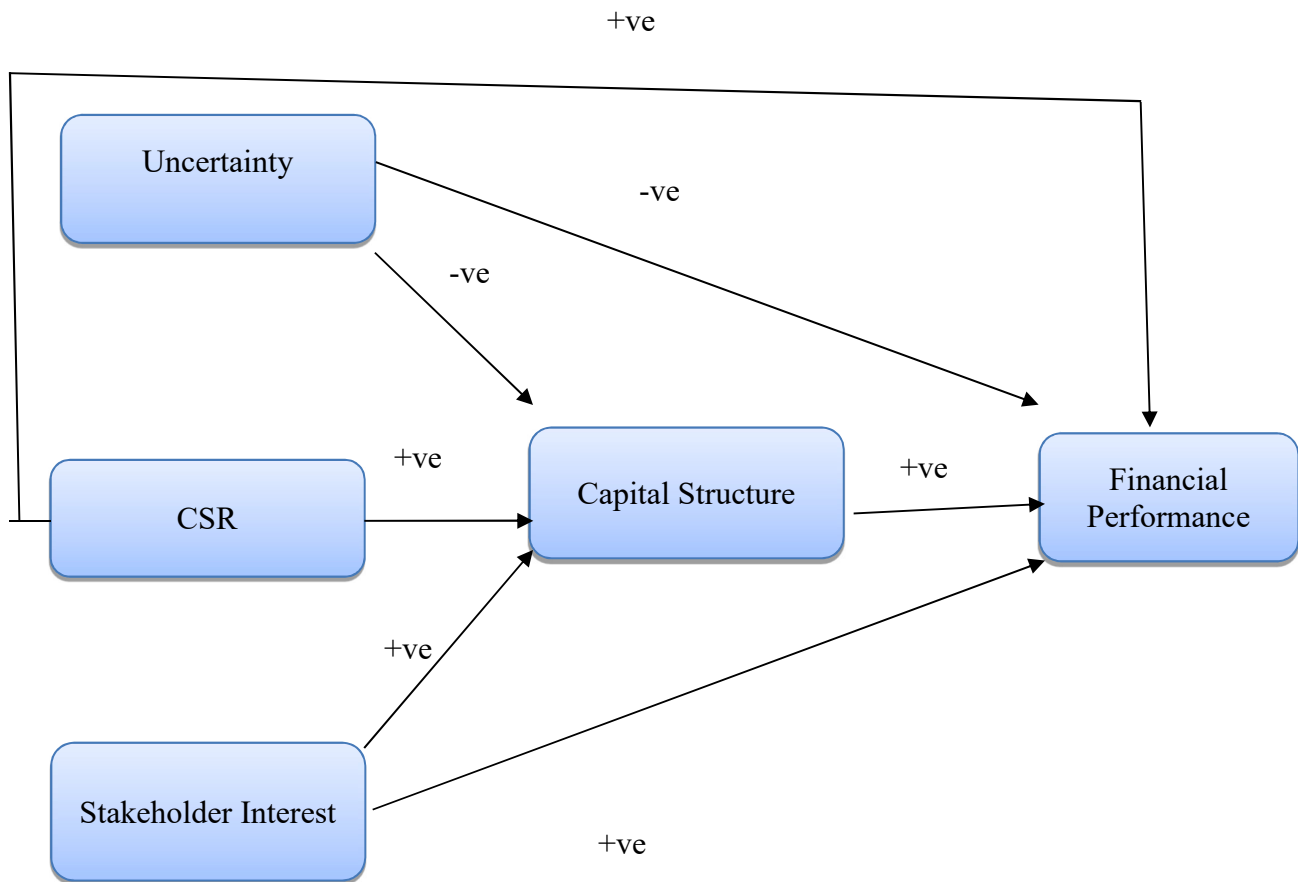


Figure 1: Conceptual Framework

3. Research Methodology

Our sample consists of the CFOs of the three leading industries (Telecommunication, Banking, and Insurance) of the Pakistani service sector listed on KSE. The entire population of firms is considered and all (84) respondents are targeted: 53 completed questionnaires were received for analysis. A purposive sampling technique is used. Our research instrument is a questionnaire. The questionnaire was completed by CFOs/Finance managers of 53 companies in Rawalpindi/Islamabad, Lahore, Karachi, and some other cities. Telephone, reference, and

company profile were used for financial personnel identification. It includes demographic details, comprising generic information, i.e. company name, age, gender, experience of the respondent, and company years in business. It also includes the sales/revenue for the period of 2012-13.

We employed confirmatory factor analysis (CFA) to finalize the instruments. Assessment of the collected data and the characteristics of the respondents were checked through the use of descriptive data. For hypotheses testing we used Structural Equation Modeling (SEM), in line with previous research (Sweeney, 2009). The scales used along with Cronbach's alpha are *Uncertainty*, *CSR*, *Stakeholder Interest*, *Financial Performance*, and *Capital Structure*.

Uncertainty: We use the 13 item scale of Verbeeten (2006) to measure uncertainty. After confirmatory factor analysis (CFA), 2 items were dropped and the Cronbach's alpha for the rest of scale is 0.910.

CSR: The 20 item scale of Tyagi (2012) is used to measure CSR. After, CFA, 8 items were dropped and the Cronbach's alpha for the rest of scale is 0.838.

Stakeholder Interest: The 10 item scale of Elijido-Ten (2006) is used to measure Stakeholder Interest. After CFA, 1 item is dropped and the Cronbach's alpha for the rest of scale is 0.852.

Financial Performance: The 9 item scale of Jiménez-Jiménez and Cegarra-Navarro (2007), and Schulz et al. (2010) is used to measure financial performance. After CFA, 5 items are dropped and the Cronbach's alpha for the rest of scale is 0.834.

Capital Structure: We use the 9 item scale of McCaffery et al. (1997) to measure capital structure. After confirmatory factor analysis, one item is dropped and the Cronbach's alpha for the rest of scale is 0.916.

4. Results

We use check the goodness of fit of the model using Goodness of fit index (GFI), adjusted goodness of fit index (AGFI), Normed fit index (NFI), Tucker-Lewis coefficient (TLI) and Comparative fit index (CFI), Root mean square error of approximation (RMSEA) and chi-square (Keramati et al. 2010). The fitness values are 0.910, 0.924, 0.092, 0.846, 0.885, and 0.894 for NFI, GFI, RMSEA, AGFI, TLI and CFI, respectively. All previous mentioned criteria indicate the best choice for our model at suggested levels.

Table 1: Index of Fit of the Model

Factors	Values	Factors	Values
Chi-square	72.717	Df	21.000
Chi-square/df	3.429	p-value	0.110
AGFI	0.846	GFI	0.924
TLI	0.885	CFI	0.894
RMSEA	0.092	NFI	0.910

Table 1 shows the results of the various measures used by McAulay et al. (2006) and Roh et al. (2005) demonstrating the desired model fitness (chi-square / DF = 3.429). After determining the model fit, the next step is estimation of the model's regression coefficients.

Hoyle and Smith's (1994) procedure is used to check mediation between the dependent variable and the independent variables and to observe the existence of full or partial mediation in the model. This procedure has two stages. First, the direct effect of the dependent variable on the independent variable is examined. The indirect effect of the independent variables on the dependent variable is

checked through the mediating variable. Full mediation exists when the relation between the dependent variable and independent variable is insignificant through mediating variable. However, if it is still significant, it provides evidence for the existence of partial mediation in the model (Hoyle and Smith, 1994). The structural equation modeling (SEM) technique captures the direct effects of the independent variables on financial performance and it verifies the mediating role of Capital Structure.

Figure 2 shows the direct effects of *Uncertainty*, *CSR*, and *Stakeholder Interest* on *Financial Performance* without the mediating variable.

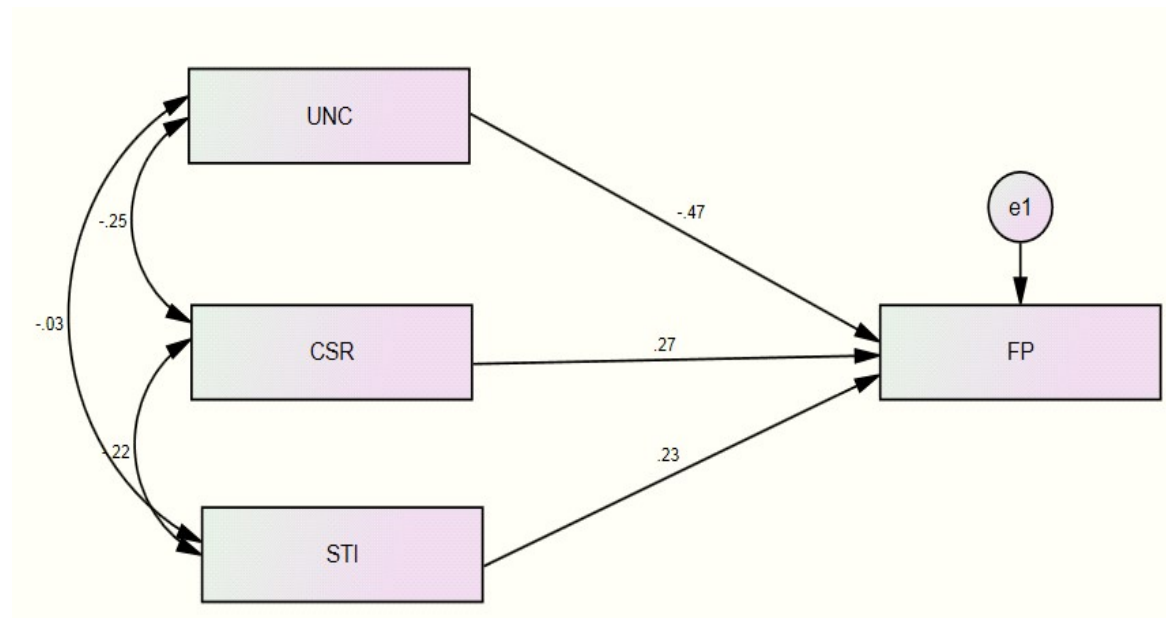


Figure 2: Structural Equation Model: Direct Effects without mediation

Table 2 shows that *Financial Performance* has a significant negative association with *Uncertainty* ($r = -0.473, p < 0.05$), and a significant positive association with *CSR* ($r = 0.271, p < 0.05$) as well as with *Stakeholder Interest* ($r = 0.231, p < 0.05$). These results provide strong support for hypotheses

H1, H2 and H3 showing that these factors are playing a significant role in determining the financial performance of an organization in the services sector.

Table 2: Regression Weights: (Direct Effects)

Variables		Estimate	P-Value	Hypothesis Support
Financial Performance	← Uncertainty	-0.473	0.000	H1 is Accepted
Financial Performance	← CSR	0.271	0.011	H2 is Accepted
Financial Performance	← Stakeholder Interest	0.231	0.026	H3 is Accepted

After analyzing the direct associations, the next step is to check the mediating effect of financial decisions, i.e. capital structure. For this purpose, the analysis is conducted in two steps: the impact of the independent variables on mediating variables is checked; then the effect of *Capital Structure* on financial performance is measured. According to Baron and Kenny (1986), the following conditions must be satisfied for a variable to work as a mediator in the model: (i) the independent variable must be related to the dependent variable; (ii) the independent variable must be related to the mediator; (iii) the mediator must be related to the dependent variable; and (iv) when the independent variable and the mediator are incorporated in the model, the direct association between the independent variable and the dependent variable should become significantly smaller (proof of the existence of partial mediation) or insignificant (proof of the existence of full mediation). Figure 3 shows the mediating effect.

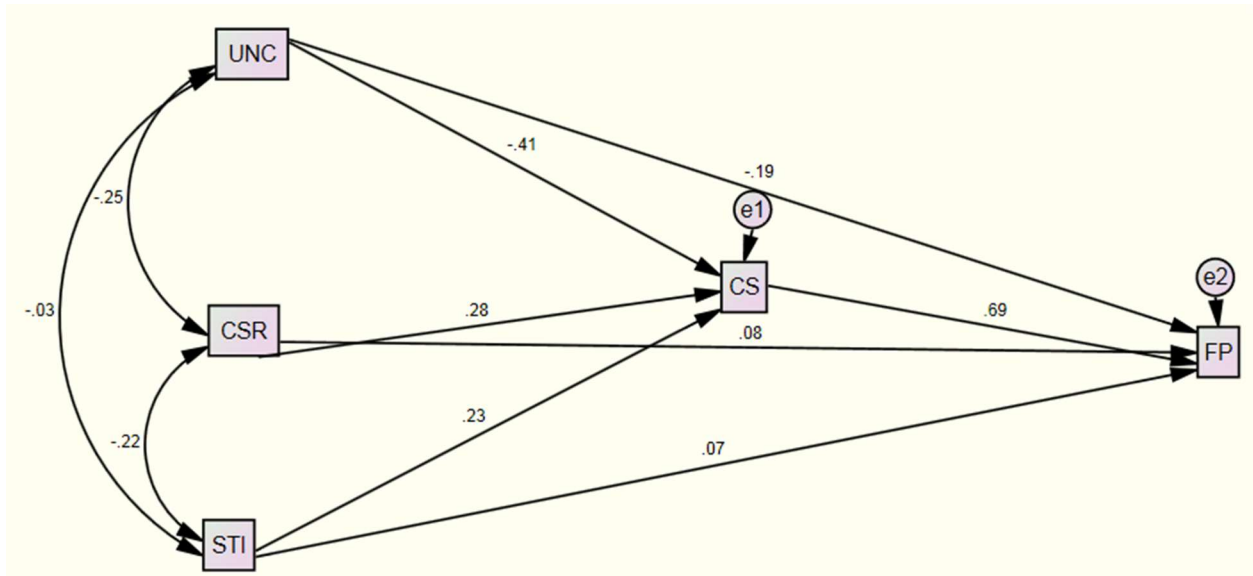


Figure 3: Structural Equation Model: Indirect Effects with Mediation (Capital Structure)

In Table 3, the regression weights of capital structure with *Uncertainty*, *CSR* and *Stakeholder Interest* are -0.413, ($p=0.000$); 0.280, ($p=0.012$) and 0.235, ($p=0.030$) respectively, which shows that a one degree increase in *Uncertainty*, *CSR* and *Stakeholder Interest* brings about a negative 41.3 percent, a positive 28 percent and a positive 23.5 percent change respectively in *Capital Structure*. In contrast, one degree change in *capital structure* brings about 69 percent positive change in *Financial Performance*. This analysis reveals that these relations are statistically significant ($p<0.05$); thus, providing evidence in favor of Hypotheses H4, H5, H6 and H7.

Table 3: Regression Weights (Indirect Effects)

	Variables	Estimate	P-Value	Hypothesis Support
Capital Structure	← Uncertainty	-0.413	0.000	H5 is accepted

Capital Structure	←	CSR	0.280	0.012	H6 is accepted
Capital Structure	←	Stakeholder Interest	0.235	0.030	H7 is accepted
Financial Performance	←	Capital Structure	0.69	0.000	H4 is accepted

Table 4 compares the direct and indirect effects of the nature of mediation. The results show that the regression weights have been reduced from -0.472 to -0.190. The negative and significant association between *Uncertainty* and *Financial Performance* with *Capital Structure* as a mediating variable suggest that it partially mediates the association between *Uncertainty* and *Financial Performance*, thus supporting hypothesis H8. Analysis of the figures for *CSR* and *Financial Performance* indicate that the former is positive (0.08) but statistically insignificantly ($p=0.317$) related to *Financial Performance* when capital structure is included as a mediating variable. This provides support for hypothesis H9. The regression weights of *Stakeholder Interest* and *Financial Performance* have been substantially reduced (0.231 to 0.07) and are statistically insignificant, thus providing evidence of complete mediation, supporting hypothesis H10.

Table 4: Comparison of Direct and Indirect Effects (Capital Structure)

Variables			Direct Effects		Indirect Effects		Hypothesis Support
			Estimate	P-Value	Estimate	P-Value	
Financial Performance	←	Uncertainty	-0.473	0.000	-0.19	0.020	H8 accepted.
Financial Performance	←	CSR	0.271	0.011	0.08	0.317	H9 accepted.

Financial	←	Stakeholder	0.231	0.026	0.07	0.353	H10
Performance		Interest					accepted.

The main purpose of our study is to investigate the capital structure decision-making for organizational financial performance of the service sector of Pakistan. Uncertainty is one of the important factors that lead to more valuable decisions (McGrath, Ferrier, & Mendelow, 2004). The results of our study reveal that as the number of years in business increase and more experience is gained, the CFOs of the companies tend to give more weight to uncertainty when evaluating the outcomes. CSR is considered to be important along with the core objectives and operations of the businesses to generate profits. Al-Tuwaijri, Christensen and Hughes (2004) propose that participating in CSR increases economic performance. Our findings also show that CSR becomes a more important part of the business as the number of years in business increases with more experienced CFOs giving it importance higher weight in decision making. Identifying stakeholder interest is one of the key objectives to gain success in compliance with the normal or routine operations of the business (Mitchell, Agle, & Wood, 1997; Freeman, 1999). The results of our study suggests that as the business grow older and the financial managers gain more experience they are inclined to pay more attention to stakeholder interests considering these to be essential for the business progress. Ahmad et al. (2012) highlight the importance of decision-making regarding capital structure because a wrong decision may have an adverse effect on performance. Our results suggest that those less experienced in financial decision making are more conscious of the capital structure to avoid any sort of business risk, and, therefore, tend to give more importance to it. Historically, a number of studies have examined the capital structure decisions that directly affect the organization's financial performance. The direct and indirect impacts of capital structure

identified in our study have supported in Chatterjee et al. (2003), Bae et al. (2011), Miller and Waller (2003), and Smith et al. (2010).

We find that uncertainty has a direct impact on the financial performance of the firm. Further, there is a mediation effect of capital structure on financial performance, supporting the results of Ittner and Larcker (2001). We find evidence of a strong CSR effect when it comes to overall financial performance, supporting the studies of Brine et al. (2007) and Preston and O'Bannon (1997). We also show that the relation between CSR and capital structure is statistically significant. The relation between stakeholder interests and financial performance is highly significant. Therefore, we conclude that the interests of stakeholders significantly impact the financial performance of an organization, in line with the findings of others (Freeman, Wicks and Parnar (2004), Waddock and Graves (2000), Lorca and Garcia-Diez (2004), and Post et al. (2002). Incorporation of capital structure as a mediator between the relation of uncertainty and financial performance results in a partially mediated impact, where uncertainty has a negative impact on capital structure employed; which in turn positively affects the financial performance, confirming the findings of previous studies (Chay & Suh, 2009; Abor, 2005). Similarly, when capital structure is used as a mediator between CSR and financial performance and between stakeholder interest and financial performance, it acts as a complete mediating variable indicating an overall positive effect on financial performance. This is consistent with the findings of Ahmad et al. (2012).

5. Summary and Conclusion

We have incorporated various statistical techniques for inferring fruitful results for the policy recommendations to the authorities concerned. The results show that decision-makers confer with the importance of capital structure decision-making practice in the service sector. Results show

that the theory and practice in different areas, for example, requirement for an optimal capital structure, have a close association. In addition, the new share issue is not the most ideal source of financing, while retained earnings and short-term / long-term borrowings are generally considered the main source of funding. We find that uncertainty, CSR, stakeholder's interest and determinants of capital structure decision-making varied with respect to a company's years in business for the year 2012-2013. Capital structure decision approaches to the financial performance of an organization also vary with respect to various age groups. Capital structure partially mediates the uncertainty and financial performance. Afterwards, capital structure completely mediates CSR and financial performance. It further mediates the stakeholder interest and financial performance.

Based on the findings, it is suggested to the CFO/Finance managers of service sector companies in Pakistan, should incorporate the uncertainty, CSR and stakeholder interest while making decisions regarding capital structure. Furthermore, it is recommended that companies shall take the initiative in CSR activities and emphasize the uncertainty situation while making decisions regarding capital structure. Service sector companies should also enhance the interest of their stakeholders by providing them with continuous dividend and give them a platform for understanding of the financial decisions for them to make better decisions to invest their resources in well performing companies. The present research can be extended by comparing high performing and low performing firms & service vs manufacturing sectors. The study could be done Working capital, financial implications in restructuring, implications of financial ratios potential trends in the sector, and treasury operations management can be undertaken as determinants of financial decision-making. Future study may include both primary and secondary data for an in-depth capture of the perceptions of financial decision makers.

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