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Strategic Drivers of Sustainable Financial Performance: A Legitimacy Theory Perspective on Aligning Strategy with Sustainability and Profitability

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ABSTRACT

This study aims to investigate how Corporate Social Responsibility (CSR) activities impact the sustainable financial performance of listed companies in Palestine, with a mediating role of frugal innovation and innovation ambidexterity. A cross-sectional research design was employed to collect the primary data from 178 respondents: CEOs, CFOs, and finance managers of listed companies in Palestine. This study implemented PLS-SEM by using Smart-PLS software. The present study revealed that CSR activities positively correlate with sustainable financial performance. Innovation ambidexterity mediates, but frugal innovation does not mediate, between CSR activities and the sustainable financial performance of listed companies in Palestine. Listed companies in conflicted zones can amplify the effect of CSR initiatives on sustainable financial performance through innovative activities. The study, grounded in legitimacy theory, shows that aligning CSR with societal expectations enhances financial sustainability, with innovation ambidexterity reinforcing this legitimacy. However, more than frugal innovation is required to maintain legitimacy with broader stakeholder alignment. This study broadens the boundary of knowledge by examining the effect of CSR activities, frugal innovation, innovation ambidexterity, and their interplay on the sustainable financial performance of listed companies in Palestine through legitimacy theory.

Keywords: CSR activities, frugal innovation, innovation ambidexterity, sustainable financial performance

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INTRODUCTION

The pandemic has exposed various companies' financial vulnerabilities. Listed companies in developing and conflicting regions like Palestine face unprecedented financial challenges compared to those in developed and stable countries (Goyal &

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Soni, 2024). Lowering spending on CSR activities during financial difficulties negatively impacts investors and stakeholders and endangers the survival of companies. A study on financial markets indicates that companies with strong financial sustainability practices have earned 8.1% higher returns in the past decade compared to 4.7% for those with weak financial sustainability practices (Jaafar et al., 2023). Companies prioritising financial sustainability face lower capital costs and operational risk, which tend to exhibit stronger long-term financial performance and greater resilience in economic turbulence (Atichasari et al., 2023). The literature does not provide a clear answer on how CSR spending can win the trust of investors and stakeholders to invest in listed companies and achieve sustainable financial performance in turbulent regions.

Frugal innovation reduces resource usage, waste, and cost while delivering sustainable, affordable products or services. It can lower companies' operational costs and improve their access to capital, which may result in sustainable development (Shahid et al., 2023). Yáñez-Valdés and Guerrero (2023) revealed that companies involved in cost-effective, innovative activities for their customers' well-being have the potential to drive financial success and create positive social and environmental impact. In addition, we need to find out how frugal innovation can help the listed companies win the investors' and stakeholders' trust in performing corporate social responsibilities and attract investment to gain sustainable financial performance.

Literature indicates that companies that can effectively manage both exploratory and exploitative innovation activities (innovation ambidexterity) can allocate their resources efficiently and adapt to changing market conditions, resulting in improved financial performance (Tajeddini et al., 2024). Many companies struggle to balance exploration and exploitation due to conflicting priorities, limited resources, and resistance to change due to unstable and unpredictable circumstances. In addition, the literature is also unable to answer how innovation ambidexterity can support the CSR activities of listed firms and achieve sustainable financial performance. This study has theoretical and practical contributions for the listed companies in underdeveloped and unstable regions like Palestine. This study distinguishes itself by using the legitimacy theory and examining the underlying mechanism of frugal innovation and innovation ambidexterity between CSR activities and the sustainable financial performance of listed companies in Palestine.

MATERIALS AND METHODS

This study employed a cross-sectional research design and a purposive sampling technique to collect primary data from the CEOs, CFOs, and finance managers of listed companies in Palestine. This study used purposive sampling as selected respondents hold decision-making roles and possess the requisite knowledge, influence over corporate strategies and financial decisions and experience relevant to the research questions. The data was collected face-to-face and through WhatsApp. We distributed 500 questionnaires and received 362. After the security phase, 318 questionnaires were finalised for data analysis. This study selected companies based on their market capitalisation, total assets, financial performance, profitability, and revenue growth. The rationale for this criterion is that larger, more financially stable firms may have more established governance practices and greater capacity for innovation. Moreover, firms with more than five years of operational history are listed on the Palestinian stock exchange.

RESULTS & DISCUSSION

Once the inner model assessment and outer model's requirements were completed, we conducted a bootstrapping procedure with 5,000 subsamples using Smart-PLS to test the hypotheses and evaluate the structural model. We used a two-tailed test at the 0.05 significance level to determine the significance of path coefficients (beta values), *t*-values, and coefficient of determination (R2).

Table 1
Direct path analysis

Hypothesis	Direct Path	Co-efficient	t-value	p-value	Decision
H1	CSR→SFP	0.407	14.699	0.000	Accepted

Notes. CSR= Corporate Social Responsibility; SFP= Sustainable Financial Performance.
Source: Author's calculation

Table 1 shows the results of direct paths. The direct path results show that CSR activities (H1: $\beta = 0.407$, $p = 0.000$, $t = 14.69$) have significant positive effects on the sustainable financial performance of listed companies.

Table 2
Mediating path analysis

Hypothesis	Mediating Path	Co-efficient	*t*-values	*p*-value	Decision	BCI-LL	BCI-UL
H2	CSR→FI→SFP	0.010	1.072	0.284	Rejected	0.341	0.459
H3	CSR→IA →SFP	0.397	13.274	0.000	Accepted	-0.022	0.050

Notes. CSR= Corporate Social Responsibility; SFP= Sustainable Financial Performance; FI= Frugal Innovation; IA Innovation ambidexterity
Source: Author's calculation

Table 2 shows the mediating effect of frugal Innovation and innovation ambidexterity on the relationship between CSR activities and sustainable financial performance. The results in Table 2 show that frugal innovation (H2: $\beta = = 0.010$, $p = 0.284$, $t = 1.072$) does not, but innovation ambidexterity (H3: $\beta = = 0.397$, $p = 0.000$, $t = 13.274$) mediates the relationship.

This section presents the results of six hypotheses supported by legitimacy theory. The study's results indicate a positive and significant relationship between CSR initiatives and the sustainable financial performance of listed companies. Hence, H1 is accepted. This result also aligns with (Song and Rimmel, 2021), who found that companies engaging in CSR activities are more likely to earn high profits. Legitimacy theory explains that CSR initiatives help meet societal expectations, maintain legitimacy, and attract more investors, customers, and regulators. By investing in local communities, environmental sustainability, and ethical business practices, Palestinian-listed companies fulfil societal responsibilities and enhance their reputation and credibility for sustainable performance.

The result of H2 reveals that frugal innovation does not mediate between CSR initiatives and sustainable financial performance. H2=Rejected. These findings align with Algarni et al. (2023), who found that cutting costs in innovative activities may not lead to a competitive advantage and positive revenue. Due to unique challenges and constraints, the legitimacy theory suggests that the CSR activities of listed firms do not guarantee legitimacy and financial benefits through frugal innovation, especially in the Palestinian business landscape. While CSR initiatives may contribute to organisational legitimacy and stakeholder trust, the ability of frugal innovation to drive sustainable financial performance seems limited in this context.

The results of H3 show that innovation ambidexterity mediates the relationship between CSR activities and sustainable financial performance. Thus, H3 is accepted. Previous studies by Abbas (2024) showed that firms involved in social responsibility tend to be more innovative and agile, aligning with innovation ambidexterity. Legitimacy theory suggests that companies can benefit from their CSR initiatives by fostering innovation and encouraging employees to pursue new ideas while leveraging existing technologies and resources. It can lead to the development of new products and services, cost-saving innovations, and improved resource efficiency, all contributing to sustainable financial performance.

CONCLUSION

Conclusively, this study emphasises the importance of CSR initiatives and innovative approaches to achieving sustainable financial performance for companies listed in Palestine. This study revealed that companies prioritising CSR activities and demonstrating a commitment to societal responsibility can achieve positive financial outcomes even during challenging economic and political circumstances. In addition, listed Palestinian firms engaging in frugal innovation activities do not play a significant role due to complicated contexts, scarcity of resources, and unrest. Furthermore, the findings suggest that listed companies can maximise the potential benefits of CSR initiatives and enhance their financial performance by adopting a balanced approach to innovation involving exploitative and explorative strategies. In particular, the study highlights the mediating effect of innovation ambidexterity on the relationship between CSR activities and sustainable financial performance. Listed companies can foster innovative activities (frugal innovation and innovation ambidexterity) and achieve sustainable financial performance by prioritising transparency in their CSR activities.

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