
A Knowledge-Based Framework for ESG Adoption in SMEs: The Roles of Stakeholder Engagement and Market Dynamism

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Abstract

Small and medium enterprises (SMEs) often face pressure to adopt sustainability-oriented practices aligned with Environmental, Social, and Governance (ESG) expectations. Their limited financial and managerial resources restrict the effective implementation of ESG practices. This study proposes a conceptual framework to explain how SMEs convert stakeholder relationships into sustainability-oriented practices through knowledge-related. Building on insights from the knowledge-based view and stakeholder theory, the study proposes that stakeholder engagement enables firms to access sustainability-related knowledge from external actors. This interaction facilitates knowledge acquisition, which supports the development of absorptive capacity, leading to better firm-level ESG practices. The framework further proposes that market dynamism moderates the relationship between knowledge acquisition and absorptive capacity, such that the conversion of acquired knowledge into organizational capabilities becomes stronger in dynamic market environments. By linking stakeholder engagement with knowledge-based mechanisms, this study contributes to the growing literature on sustainability in SMEs. It also explains how SMEs can use stakeholder relationships to develop ESG-oriented practices.

Keywords: SMEs, stakeholder engagement, absorptive capacity, ESG

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1. Introduction

Sustainability is important for organizations as businesses are expected to address environmental, social, and governance (ESG) issues in their operations. While large corporations possess the financial and managerial resources required to implement sustainability strategies, small and medium enterprises (SMEs) face resource constraints to adopt such practices. Despite these constraints, SMEs play a critical role in economic development and environmental impact, making their participation in sustainability initiatives more and more important. SMEs can address their limitations by using their relationships with external stakeholders. Stakeholders such as customers, suppliers, communities, and regulatory agencies can provide knowledge related to sustainability practices. Stakeholder theory suggests that stakeholder engagement enables firms to access diverse perspectives and knowledge that can support organizational learning and decision making.

However, access to external knowledge does not guarantee its effective utilization. Firms must possess the capability to recognize the relevant knowledge and apply it to organizational activities. This capability, referred to as absorptive capacity, enables firms to transform acquired knowledge into organizational capabilities useful for innovation (Cohen and Levinthal, 1990; Zahra and George, 2002). Although earlier studies have examined stakeholder relationships and sustainability practices separately, less attention has been given to the knowledge-based mechanisms in the adoption of ESG practices in SMEs. In particular, the processes through which external knowledge obtained from stakeholders is converted into organizational capabilities remain underexplored. To address this gap, the study proposes a conceptual framework that explains how stakeholder engagement promotes knowledge acquisition, strengthens absorptive capacity, and ultimately supports ESG practices in SMEs. In addition, market dynamism is considered as a contextual factor that may influence this process.

2. Theoretical Background

2.1. Stakeholder Theory

This study is based on stakeholder theory, which emphasizes that organizations create value not only for shareholders but also for a broader set of stakeholders such as customers, suppliers, employees, and communities. Organizations benefit when they actively engage stakeholders and incorporate their perspectives into decision-making processes (Freeman, 1984). For SMEs, stakeholder engagement is particularly important because these firms often operate with limited internal resources. As a result, SMEs frequently interact with external stakeholders to obtain knowledge about market conditions and sustainability issues (Jenkins, 2009).

2.2. Knowledge-Based View of the Firm

The Knowledge-Based View (KBV) of the firm considers knowledge as a strategic resource that enables organizations to achieve competitive advantage. According to this perspective, firms function as systems that integrate and apply specialized knowledge (Grant, 1996). Organizational

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performance depends on the ability to acquire and use knowledge effectively. To support innovation and strategic development, firms often engage with external actors to access relevant knowledge (Grant, 1996; Spender, 1996). For SMEs, knowledge acquisition is important as they have limited research and development capabilities.

2.3. Absorptive Capacity

Absorptive capacity refers to a firm's ability to recognize valuable knowledge, assimilate it, and apply it for organizational purposes (Cohen & Levinthal, 1990). From a dynamic capability perspective, absorptive capacity consists of four processes including recognition, assimilation, transformation, and exploitation of knowledge (Zahra & George, 2002). For SMEs, this capability facilitates the effective utilization of knowledge in building organizational capabilities.

2.4. Market Dynamism and ESG Practices

Market dynamism refers to the rate and unpredictability of changes in market conditions such as customer preferences, competitive actions, and product demand. In dynamic markets, firms must continuously update their knowledge and capabilities to respond effectively to changing conditions (Dess & Beard, 1984; Jansen et al., 2006). For SMEs, such conditions necessitate the need for transforming external knowledge into organizational capabilities. ESG practices represent organizational initiatives aimed at promoting sustainability, ethical governance, and social responsibility (Eccles et al., 2014). Although SMEs face resource limitations in implementing ESG initiatives, stakeholder interactions can provide valuable knowledge.

3. Conceptual Framework

The conceptual framework explains how stakeholder engagement shapes ESG practices in SMEs. Based on stakeholder theory and the knowledge-based view of the firm, the framework suggests that stakeholder interactions enable SMEs to acquire external knowledge related to sustainability. However, the benefits of knowledge depend on the firm's absorptive capacity, which determines how effectively knowledge is utilized. Market dynamism strengthens the relationship between knowledge acquisition and absorptive capacity, as rapidly changing environments increase the need for interpreting and applying new knowledge.

3.1. Stakeholder Engagement and Knowledge Acquisition

Stakeholder engagement refers to the interactions through which firms communicate and collaborate with stakeholders such as customers, suppliers, and communities. Organizations often benefit when they allow stakeholders to participate in the decision-making processes. Stakeholders provide valuable knowledge and feedback (Freeman, 1984). Such interactions facilitate the flow of information that helps firms understand market trends, regulatory conditions, and sustainability-related expectations. As SMEs operate with limited financial and technological resources, stakeholder relationships represent an important source of external knowledge (Jenkins, 2009). SMEs rely on informal relationships with customers, suppliers, and

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community members to obtain practical insights into business opportunities and sustainability practices.

Proposition 1: Stakeholder engagement positively influences knowledge acquisition in SMEs.

3.2. Knowledge Acquisition and Absorptive Capacity

Knowledge acquisition refers to the process through which organizations obtain knowledge from external sources including stakeholders. For SMEs, acquiring external knowledge is particularly important because these firms often lack extensive internal research and development resources. However, obtaining knowledge alone does not automatically enhance organizational capabilities. Firms must also possess the ability to recognize the value of external knowledge and integrate it into their existing knowledge base. Absorptive capacity explains this capability and refers to a firm's ability to recognize, assimilate, and apply external knowledge (Cohen & Levinthal, 1990). Later studies conceptualized absorptive capacity as a dynamic capability involving knowledge acquisition, assimilation, transformation, and exploitation (Zahra & George, 2002). Through interaction with stakeholders, SMEs accumulate knowledge and learning experience, which strengthens their ability to interpret and utilize external knowledge effectively.

Proposition 2: Knowledge acquisition positively influences absorptive capacity in SMEs

3.3. Absorptive Capacity and ESG Practices

Absorptive capacity reflects a firm's ability to recognize, assimilate, and apply external knowledge to organizational activities. It supports the interpretation of external information and its integration into internal processes. In the context of sustainability, absorptive capacity enables firms to translate knowledge about environmental regulations, social expectations, and governance standards into organizational practices. For SMEs, this capability is particularly important because these firms rely on knowledge obtained from stakeholders and external networks. By assimilating and applying such knowledge, SMEs can implement sustainability initiatives such as environmentally responsible production practices, socially responsible activities, and transparent governance mechanisms. Thus, absorptive capacity plays a central role in the adoption of ESG practices.

Proposition 3: Absorptive capacity positively influences ESG practices in SMEs.

3.4. Moderating Role of Market Dynamism

Market dynamism refers to the rate and unpredictability of changes in a firm's external environment, including technological developments and customer preferences (Dess & Beard, 1984). In highly dynamic environments, firms must continuously update their knowledge and capabilities to respond to frequent changes. Rapid environmental changes create uncertainty and require organizations to interpret new information and adapt their strategies (Jansen et al., 2006). For SMEs, dynamic markets increase the importance of transforming acquired knowledge into organizational capabilities. Firms with higher absorptive capacity can better utilize newly

acquired knowledge to address environmental challenges. Consequently, when market conditions are highly dynamic, the effect of knowledge acquisition on developing absorptive capacity becomes stronger.

Proposition 4: Market dynamism positively moderates the relationship between knowledge acquisition and absorptive capacity in SMEs.

Conceptual model diagram is shown in Figure 1.

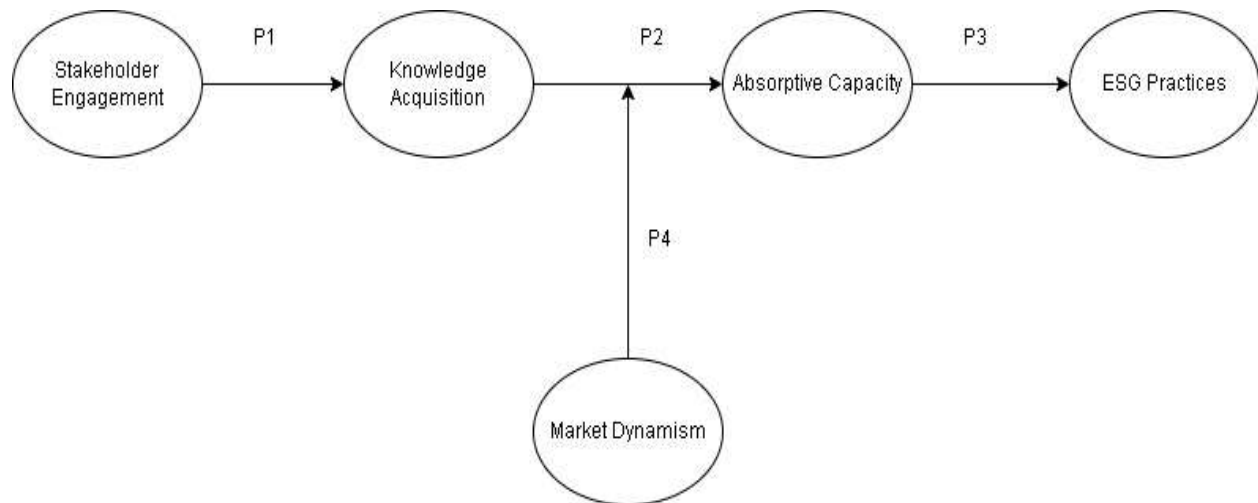


Figure 1: Conceptual Diagram

Source: Author's own work

4. Discussion

The framework explains how SMEs translate stakeholder relationships into sustainability-oriented organizational practices. Based on stakeholder theory and the knowledge-based view of the firm, the framework proposes that stakeholder engagement enables firms to access external knowledge related to sustainability and responsible business practices. However, acquiring knowledge alone does not automatically lead to organizational outcomes. Firms must possess the ability to interpret and utilize this knowledge effectively. In this context, absorptive capacity enables firms to assimilate and apply externally acquired knowledge. This capability, in turn, supports the implementation of ESG practices. The framework also introduces market dynamism as a contextual factor that strengthens the conversion of acquired knowledge into organizational capabilities within SMEs.

5. Theoretical Implications

This study contributes to the literature on SMEs, sustainability, and organizational learning in several ways. First, it extends stakeholder theory by emphasizing stakeholder engagement as a mechanism through which SMEs access external knowledge. Second, the framework advances the knowledge-based view of the firm by highlighting knowledge

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acquisition and absorptive capacity as processes through which firms transform external knowledge into organizational capabilities. Third, the study contributes to the growing literature on ESG adoption in SMEs. Finally, the inclusion of market dynamism highlights the role of changing market conditions in shaping knowledge conversion processes within SMEs.

6. Managerial Implications

The framework offers practical implications for SME managers seeking to implement sustainability-oriented practices. First, managers should recognize the importance of stakeholder engagement with customers, suppliers, communities, and regulators, as these interactions provide insights into sustainability expectations and market trends. Second, SMEs should strengthen internal learning capabilities by developing absorptive capacity, enabling them to interpret and apply externally acquired knowledge effectively. Organizational learning mechanisms such as training and knowledge sharing can support this process. Third, managers should remain attentive to market dynamism, as rapidly changing market conditions require firms to continuously update their knowledge and capabilities to remain competitive while adopting ESG practices.

7. Future Research Directions

The framework offers several directions for future research. First, empirical studies may examine the proposed relationships using survey data from SMEs to test the mediating roles of knowledge acquisition and absorptive capacity. Second, future research may explore additional contextual factors influencing ESG adoption, including institutional pressures and regulatory environments. Third, scholars may examine how stakeholder engagement influences different ESG dimensions. Finally, comparative studies between SMEs and large firms may provide insights into differences in sustainability adoption mechanisms.

8. Conclusion

The study presents a conceptual framework explaining how SMEs transform stakeholder interactions into sustainability-oriented practices. It highlights that stakeholder engagement enables SMEs to access external knowledge relevant to sustainability initiatives. Through knowledge acquisition, firms obtain information related to responsible business practices, while absorptive capacity enables them to assimilate and apply this knowledge. The framework also highlights the role of market dynamism in strengthening the transformation of acquired knowledge into organizational capabilities. Overall, the framework offers a basis for understanding how SMEs can develop ESG practices despite resource limitations.

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