# The Investigation of the Relationship between Corporate Social Responsibility and Debt Cost in Tehran Stock Exchange Listed Companies

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**Abstract**

*This paper aims to measure the relationship between corporate social responsibility and cost of debt in 65 companies listed in Tehran Stock Exchange (TSE) between 2008 and 2012. Social and environmental criteria and effective rate cost of debt for long-term loans are used in order to measure social responsibility and cost of debt, respectively in panel data regression analysis. The findings show that there is no significant relationship between social responsibility and cost of debt in Iranian companies which are active in an emerging capital market. This could be due to the lack of low rate loans as a source of financing in Iran.*

## 1. Introduction

There is no single definition of the social phenomena. Corporate social responsibility is not an exception. The purpose of corporate social responsibility is to strengthen the cohesion and unity among the organization's activities and values in a way that benefits all stakeholders of the firm, including shareholders, customers, employees and investors. In other words, organizations might profit more in a long term by balancing their financial benefits with the welfare of the community. Corporate social reporting is the tool for building community awareness on corporate social responsibility (Foroughi et al., 2008).

In the twenty-first century, the role of the corporate sector has changed dramatically. Corporate social responsibility (CSR) has beheld an astonishing ascendancy at the global level. The notion of CSR recognizes commitment to operate in a socially responsible manner. It takes into consideration the social and environmental implications of corporate financial decisions. Nowadays, purpose of corporate sector is not restricted to earning profit, but also to contribute to the society. Managers of 21st century accept the fact that

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maximum profit is not the only objective of the business unit, but development of employees and other stakeholders of the outside world is equally important (Baxi and Majumdar, 2012). CSR used to be and still continues being an important factor of business reputation, social image, stability, and capitalization of the company (Morozova and Britvin, 2013).

The growing literature on social responsibility explores the relationship between CSR and financial markets (Serafeim et al., 2014). Specially, creditors are paying particular attention to the quality of financial information. Creditors as an important group to offer financial resources to companies need qualified information for taking decisions. Good financial reporting assures the creditors in their decision making and reduces information risk (Ahmad et al., 2010). It also offers risk reduction to firms as one of the potential benefits of investing in CSR (Izzo and Magnanelli, 2012). However, in emerging markets, particularly in Iranian context; it seems that stakeholders do not pay enough attention to CSR for their economic decisions.

The relation between CSR and cost of debt is important. The literature announces a negative relation between cost of debt and CSR (Najah and Jarboui, 2013). Corporate social responsibility reduces business risk of the firm. Izzo and Magnanelli (2012) present that an efficient market must recognize "premium financial ethics" for socially responsible firms, corresponding to a lower cost of debt. Therefore, socially responsible behavior and social responsibility investments cause risk reduction, and consequently an improvement of the company's financial performance (such as stakeholder theory argues) since banks and other creditors offer the best conditions for loan agreement to these companies. On the contrary, if financial market does not recognize a value for CSR, socially responsible firms will suffer a competitive disadvantage because of additional costs (Najah and Jarboui, 2013). To justify an "ethical premium" on the cost of debt paid by the firms, Izzo and Magnanelli (2012) believe that the creditors are regarded as the agents between all groups of stakeholders. However, Girerd-Potin et al., (2011) suggest that the least ethical companies are using more debt to escape from the punishment of the financial market. They believe banks do not impose penalties on unethical borrowers. It explains that the debt market is less able to provide companies with the ethical expectations of investors.

Therefore, the present study aims to investigate the relationship between corporate social responsibility and cost of debt in TSE listed companies through considering non-financial reporting and corporate social performance report. In fact, we look into the issue of whether creditors consider the quality of social performance reporting of companies which ask for credit.

## 2. Theoretical framework

In most developed countries there are institutes that yearly assess and rate companies based on social and environmental criteria. Among them we can refer to KLD in the US, CSID in Canada, and VIEGO in Europe (Zamani, 2010). Today, the CSR has gained various roles in business strategies through a deep effect in organizations and in the performance of the companies. Investment in CSR can give value to company through influencing different aspects such as increasing the credibility and reputation of the company, reducing risk and cost of debt, and improving company's economic performance (Izzo and Magnanelli, 2012). Moreover, investment funds and other financial institutions encourage companies to improve their activities based on various responsibility criteria (Bassen et al., 2006). In order to invest in companies, large institutional investors give priority to those which pursue certain social activities (Gunester et al., 2010).

The significant increase in CSR activities has recently led to research in the relationship between corporate social responsibility and financial performance. Up to now these studies have given out different findings concerning the effect of CSR (Jiao, 2010). These different results indicate different theoretical perspectives concerning the relationship between CSR and financial performance.

Over the past years, companies from around the world increased their payments through increasing resources devoted to charity work under the title of investments in CSR. One of the reasons for this trend is the idea that there is a relationship between CSR and the company's performance. Thus, the social responsibility has acquired a different role in business strategies, becoming an issue of governance more than a mere communication activity, with a deeper impact both on organizational and financial performance (Izzo and Magnanelli, 2012). This is why a lot of research has been done on corporate financial decisions and the factors affecting the choice of capital structure of companies.

Some theoretical studies on financing through debt or equity have been done by companies that choose optimal debt ratio according to the principle of cost-benefit. Difference between debt and equity capital is that debt financing connote a definitive contractual arrangement. Debt holders have no concrete control on the use of the funds they provide, and must rely on public financial reports when making their decisions and monitoring their claims. Debt financing is the only way that private firms can obtain financing through external funding. For many firms, debt financing is preferable to equity financing for several reasons. Funds acquired through debt financing are usually less costly for the firm as interest paid on debt is tax deductible, i.e. there is a debt tax shield at the corporate level. In addition, debt financing can frequently be less complicated and more

cost-efficient as firms do not have to comply with a long series of government laws and regulations as in the equity financing case. Similarly, debt financing does not require firms to suffer, at least to the same extent, the periodic informational costs towards shareholders (mailings, issuing corporate reports, and holding shareholder meetings) that are unavoidable for public firms. Accordingly it is obligatory for corporate managers to know what the determinants of the cost of debt financing are, as well as in which direction and by how much they affect this cost (Pavelin et al, 2011). This study investigates then the extent to whether corporate social performance can influence corporate spreads and the credit quality of bonds.

Traditionally, the tax savings resulting from deducting the cost of interest from benefit as the first advantage of financing is related to loans. While the investors are busy deciding on the companies and institutions to invest in, the creditors assess the risk curve of the company. This curve determines the creditors' expected return which is the cost of interest (Ahmadpour et al., 2010). Other benefits include committing managers to operate efficiently (Jensen, 1986) and engaging lenders to monitor the firm (Jensen and Meckling, 1976). One of the components of investment risk in companies is its information risk, i.e. the higher the precision and the quality of information provided by the company, the lower will be the risk of the company from the point of view of the investors (Kordestani and Majidi, 2007). High level of transparency in information reduces information asymmetry between companies and investors which in turn reduces the risk (Serafeim et al., 2014).

Today, corporate social reporting which can make valuable information available to users of accounting information, such as investors is considered as one of the important approaches in accounting (Khoshtinat and Raee, 2004).

This study may be useful for creditors and managers for the following reasons, particularly in emerging markets:

- Help the managers comprehend the effect of investment in CSR on the cost of financing, and help them employ it in their strategic plans.

- Given the level of financial distress, creditors would attend to CSR reporting in order to measure the return of capital.

- Managers are encouraged to disclose social performance and access to financial resources with lower interest.

Therefore, the major question of this study is whether there is a significant relationship between corporate social responsibility and cost of debt in the Iranian context. This issue has already been investigated by some early studies. The results of Izzo and Magnanelli

(2012) indicate that companies with a high social performance scores have a consequently lower cost of debt than other companies. Izzo and Magnanelli (2012) also find that investing in CSR reduces the risk of the company.

Servaes and Tamayo (2013) investigate the effect of social responsibility on firm value. Their results indicate that there is a positive relationship between social responsibility and firm value where customer or public awareness, through advertising, is higher. Their results also show that the effect of awareness on the relationship between social responsibility and corporate value in little-known companies is negative.

In a study carried out by Piot and Missonier-Piera (2008) on a sample of large listed French companies between 1999 and 2001, the effects of three corporate governance characteristics (namely Board Independence, the existence of a compensation committee of non-executive directors, and the presence of significant institutional shareholders) on debt financing cost are investigated. Their findings show an inverse relationship between the ex-post cost of debt and the aforementioned corporate governance characteristics. The research offers two sets of implications. Academically, it suggests that although the study supports the advantages of more effective monitoring of debt holders' agency risk, the same does not apply to the information risk. Moreover, regarding policy implications, the study gives some insights to the institutions for following the standard qualities of borrowers' corporate governance, as well as optimizing loan conditions.

Pavelin et al. (2011) analyze the effect of different dimensions of social performance on debt pricing as well as credit quality assessment of bonds. The analysis based on an extensive dataset consisting of more than 3000 bonds issued by 742 companies active in 17 different industries shows that supporting community involvement and high levels of product quality, and avoiding workforce related disputes in the company can lower the risk associated with corporate bonds and thus reduce cost of debt for large companies. Mishra et al. (2011) affirm that companies which have invested in social responsibility disclosure in their reports have a consequently lower cost of capital than those without this disclosure.

Bassen et al. (2006) examine the relationship between social responsibility and companies' financial performance. In order to measure social responsibility, they take into account three dimensions: economic, environmental, and community involvement. They conclude that companies with high social performance have lower risks, and lower cost of capital. Ahmadpour et al. (2010) study the effect of corporate governance and audit quality on cost of financing through borrowing. Their findings show that the presence of major institutional shareholders among the others and their efficient monitoring significantly

lower cost of debt for companies. But this is not the case for audit quality. Morton et al. (2000) analyze the relationship between conservative accounting and cost of debt. Their results show that companies in which there is a great difference between creditors and stakeholders over dividend policy use conservative accounting that leads to lower cost of debt.

Stekki (2001) investigate the relationship between disclosure quality of the company and cost of debt. Their results show that there exists an inverse relationship between cost of debt and disclosure quality. Geile (2000) examine the association between managed operating cash flow and the cost of debt. Their results indicate that the cost of debt has a negative impact on operating cash flows. Moreover, when firms manage operating cash flow, bondholders are more motivated to review firm information and manage operating cash flow information.

Sengupta (1998) investigates the relation between the quality of a firm's disclosure and its cost of debt. The measure for the quality of the disclosure is the firm rating by financial analysts. The study uses two different measures for cost of debt: 1) the yield to maturity on new issues, (2) the total interest expenses of the new issues. Results show both measures to be negatively correlated to the measure for the quality of the disclosure. Moreover his results imply the specific importance of disclosure to firms with insecure future prospects, using the standard deviation of daily stock returns as a measure for future insecurity.

According to the aforementioned literature we can conclude that disclosure of information on firm's SCR to stakeholders can reduce risk of the firm, and its cost of debt.

## 3. Data and Model

The main objective of this study is to investigate the relationship between corporate social responsibility and cost of debt. In this sense, we examine whether the extent of social responsibility disclosure, or in other words the companies' social performance disclosure, can lower cost of debt for companies listed in TSE. Financing system in Iran is usually based on credit (debt) although the Iranian capital market is growing recently. Therefore, disclosure of corporate social responsibility can be seen as a mechanism to reduce the cost of debt for Iranian companies.

Our sample consists of 65 listed companies in TSE for the 5-year period from 2008 to 2012. We first include all TSE listed companies into the sample, but through back-step procedure, we eliminate the ones which do not match following criteria:

1) The firm should have been listed in TSE before 2008.

2) Full reports of the board of directors and social performance should be available from 2008 to 2012.

3) End of financial year (March 19) should not have changed during the period of the study.

4) The firm should not be one of the investment or financial intermediation companies, because the nature and classification of financial statement items are different.

### 3.1  Variables of the Model

The dependent variable of the model is cost of debt. In order to measure cost of debt rate the following equation is used (Neveu, 2010):

$$K_d = K_m(1-t) \qquad (1)$$

where $K_d$ is rate of after-tax cost of debt, $K_m$ denotes effective rate of pre-tax cost of debt based on annual rate, and $t$ represents tax rate. In order to obtain effective rate of cost of debt, regulations of credit facilities, provided by banks for the industrial and manufacturing units, are analyzed. Moreover, we use the ratio of paid-tax to income before tax in order to calculate the effective annual tax rate of each of the studied companies:

$$t = \frac{\text{paid tax}}{\text{income before tax}} \qquad (2)$$

The explanatory variable of the model is social responsibility. Following the KLD approach, the social responsibility in this study consists of four dimensions (environment, community, employee relations, and product characteristics). Each dimension has a score according to its own strengths and concerns. All four scores are then added up and one overall score is obtained for social responsibility rank of a firm. The suggested model is as follows:

$$\text{CSRs} = \text{CSRCOMs} + \text{CSREMPs} + \text{CSRENVs} + \text{CSRPROs} \qquad (3)$$

where CSRs denotes total social responsibility score, CSRCOMs is community involvement disclosure score, CSREMPs is employee relations disclosure score, CSRENVs is environment disclosure score, and CSRPROs is product feature disclosure score. The score of each dimension ($\text{CSRCOMs}, \text{CSREMPs}, \text{CSRENVs}, \text{CSRPROs}$) and is calculated as follows:

$$\text{CSRCOMs} = \sum \text{Strenghts} - \sum \text{Concerns} \qquad (4)$$

## Table 1. Social responsibility dimensions

| Dimensions of social responsibility | Score | Concerns | Strengths |
|---|---|---|---|
| **Community** | | -Investment Controversies<br>-Negative Economic Impact<br>-Indigenous Public Relations<br>-Tax Disputes<br>-Other Concerns | -Charitable Giving<br>-Impact Innovative Giving<br>-Non-IRI Charitable Giving<br>-Support for Housing<br>-Support for Education<br>-Indigenous Peoples Relations<br>-Volunteer Programs<br>-Other Strengths |
| **Environment** | | -Hazardous Waste Regulatory Problems<br>-Ozone Depleting Chemicals<br>-Substantial Emissions<br>-Agricultural Chemicals Communications<br>-Climate Change<br>-Other Concerns | -Beneficial Products and Services<br>-Pollution Prevention<br>-Recycling<br>-Clean Energy<br>-Property, Plant, and Equipment<br>-Other Strengths |
| **Product characteristics** | | -Product Safety<br>-Marketing/Contracting Concern<br>-Other Concerns | -Quality<br>-R&D/Innovation<br>-Benefits to Economically Disadvantaged People<br>-Other Strengths |
| **Employee Relations** | | -Union Relations<br>-Health and Safety Concern<br>-Workforce Reductions<br>-Retirement Benefits Concern<br>-Other Concerns | -Union Relations<br>-No-Layoff Policy<br>-Cash Profit Sharing<br>-Employee Involvement<br>-Retirement Benefits Strength<br>-Health and Safety Strength<br>-Other Strengths |
| | | | Aggregated score |

Source: Mishra et al., 2011.

Table 1 indicates social responsibility dimensions together with their strengths and concerns according to Mishra et al. (2011).

*3.2 KLD Approach*

KLD is an independent institute established in 1988 to rate companies. It provides investors with information on CSR. The KLD approach includes wide range of CSR

standards derived from various sources such as governmental and non-governmental organizations, international media, annual reports, company statements and disclosures. The KLD model gives us continuous data on CSR contrary to the existing models on social responsibility that are mostly based on questionnaires. For instance, a company may receive a prize for environmental matters in one year, while having incurred a fine the year before for polluting the environment.

We also employ some control variables in our research according to the research conducted by Hail and Leuz (2006) and Dhaliwal et al. (2006). The control variables are as follows:

*Size*: The size of the company calculated as the logarithm of firm's total assets.

*BTM*: The ratio of book value to market value of equity.

*LEV*: The leverage ratio calculated as the ratio total debt to market value of equity.

*BETA*: Systematic risk (market risk). BETA reflects the sensitivity of firm returns to market returns. It is calculated using Rahavard Novin software (a database for financial information of listed companies in TSE).

The estimated equation takes then the following form:

$$K_d = a + \alpha CSRs + \beta Size + \lambda BTM + \mu LEV + \nu BETA \tag{5}$$

## 4. Estimation Results

Before estimating our model, we first present descriptive statistics of dependent and explanatory variables in Table 2. Then, in order to choose the appropriate methodology, we implement Chow and Hausman tests. Depending on the test results, we opt for the pooled panel model (see Table 3).

As the distribution test, we use Kolmogorov-Smirnov, Shapiro-Wilk and Jarque-Bera tests. As the measured significance levels for all variables are smaller than %5, the normal distribution of variables is rejected (Table 4). Because of the large sample size and the fact that sample distribution is single-exponential, although the distribution is not normal, the results of parametric tests are still reliable.

Fisher's exact test or the overall regression test determines the presence of a linear relationship between the explanatory and dependent variables of the model. Since estimated statistics are larger than the critical value (in other words, the significance level is inferior to %5 level), we affirm the existence of a linear relationship between explanatory and dependent variables of the study. Moreover, the Durbin-Watson test indicates that there is no autocorrelation between the explanatory variables, since Durbin-

Watson statistics for the fitted model is in the range of acceptable values. Besides, residual distribution test shows that the normal distribution of model residues is rejected. However, since the distribution is single-exponential with no severe skewness, the lack of normal distribution is explainable (see Table 5). Finally, Pearson correlation test indicates that there is no multicollinearity problem between the explanatory variables of the model as shown in Table 6.

## Table 2. Descriptive statistics of the variables

| Variables | Obs. | Mean | Std. Error | Variance | Skew. | Kurt. | Deviation coefficients | |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| | | | | | | | Skew. | Kurt. |
| Corporate social responsibility | 325 | 13.775 | 3.889 | 15.125 | 0.240 | -0.683 | 1.777 | -2.533 |
| Cost of Debt | 325 | .0192 | 0.042 | 0.002 | -10.167 | 156.155 | 75.174 | 579.010 |
| Book-to-market value of equity | 325 | .6146 | 1.020 | 1.040 | -0.917 | 40.800 | -6.776 | 151.282 |
| Leverage ratio | 325 | 2.2207 | 3.970 | 15.760 | 5.185 | 36.763 | 38.335 | 136.313 |
| Company size | 325 | 13.776 | 1.497 | 2.242 | 0.844 | 0.633 | 6.237 | 2.348 |
| Systemic risk | 325 | .4809 | 2.934 | 8.607 | -9.443 | 151.946 | -69.712 | 562.549 |

## Table 3. Results of Chow and Hausman tests

| Group Model | The objective test | Chow test | | | Hausman test | | |
| --- | --- | --- | --- | --- | --- | --- | --- |
| | | F-statistic | Level of error | Results | Chi-square statistic | Level of error | Results |
| Corporate social responsibility | Test Period | 0.853180 | 0.4925 | Intercept equal to | - | - | - |
| | Test sections | 0.860366 | 0.7605 | Company slope equal | - | - | - |

## Table 4. Results of distribution tests

| Variable | Obs. | Jarque-Bera | | Shapiro-Wilk | | Kolmogorov-Smirnov | |
|---|---|---|---|---|---|---|---|
| | | Level of error | Statistics | Level of error | Statistics | Level of error | Statistics |
| Cost of debt | 325 | 0.000000 | 324172.6 | .000 | .407 | .000 | .301 |
| Corporate social responsibility | 325 | 0.008372 | 9.565624 | .000 | .976 | .000 | .091 |
| Book-to-market value of equity | 325 | 0.000000 | 21919.02 | .000 | .519 | .000 | .259 |
| Leverage ratio | 325 | 0.000000 | 19168.56 | .000 | .497 | .000 | .288 |
| Company size | 325 | 0.000000 | 43.06471 | .000 | .953 | .000 | .090 |
| Systemic risk | 325 | 0.000000 | 306872.7 | .000 | .335 | .000 | .296 |

## Table 5. Linear correlation test, Durbin-Watson test and Residual distribution test

| Linear correlation test | | Durbin–Watson test | | Residual distribution test | |
|---|---|---|---|---|---|
| F-statistic | Level of err | Calculated | Acceptable range | Statistics J_B | Level of err |
| 3.057395 | 0.006627 | 1.573829 | 1.5-2.5 | 200621.1 | 0.000000 |

## Table 6. Results of correlation test between explanatory variables

| Variable | **CSRs** | BTM | LEV | SIZE | BETA |
|---|---|---|---|---|---|
| Corporate social responsibility | 1 | .135 | .100 | .413 | .103 |
| Book-to-market value of equity | .135 | 1 | .138 | .059 | -.005 |
| Leverage ratio | .100 | .138 | 1 | .232 | .047 |
| Company size | .413 | .059 | .232 | 1 | .127 |
| Systemic risk | .103 | -.005 | .047 | .127 | 1 |

**Table 7. Results of regression analysis**

| Dependent variable: Cost of debt, Number of periods: 5, Number of firms: 65 Total Obs.: 325 | | | | | | |
|---|---|---|---|---|---|---|
| Variable name | | | Coefficient | Standard error | T-statistics | Significance |
| $\beta_0$ | C | Constant | -0.026965 | 0.026997 | -0.998811 | 0.3188 |
| $\beta_1$ | CSRs | Disclosure of corporate social responsibility | 0.000185 | 0.000540 | 0.343359 | 0.7316 |
| $\beta_2$ | BTM | Book-to-market value of equity | 0.008273 | 0.003028 | 2.732402 | 0.0067 |
| $\beta_3$ | LEV | Leverage ratio | -0.000399 | 0.001103 | -0.361550 | 0.7180 |
| $\beta_4$ | SIZE | Company size | 0.002649 | 0.002191 | 1.208952 | 0.2278 |
| $\beta_5$ | BETA | Systemic risk | 0.003213 | 0.002525 | 1.272076 | 0.2045 |
| $\beta_6$ | AR(1) | First–Order Autoregressive | -0.088634 | 0.146115 | 0.606605 | 0.5447 |
| Coefficient of determination | | | 0.067856 | Durbin – Watson | | 1.573829 |
| Adjusted coefficient of determination | | | 0.045662 | F-statistic | | 3.057395 |
| KD = -0.026 + 0.00018*CSRS + 0.00827310127983*BTM - 0.00039*LEV + 0.0026*SIZE + 0.0032*BETA + [AR(1)=-0.0886] | | | | | | |

According to the estimation results of the pooled panel model shown in Table 7, the variable disclosure of corporate social responsibility has no effect on cost of debt. The results of this research are not in line with previous empirical works in the literature, since they show a significant negative relationship between social performance and cost of debt. This may be due to the lack of cheap debt as a source of financing in Iran. The effective rates of loans in Iranian banks are rather high. Moreover, banks assessments on the eligible firms have a complicated and long process. Because, the restrictive policy of banks and determination of loan rates by the Iranian Monetary Council cause that the rate is not determined based on the risks of companies using the credit facilities.

For control variables, only BTM is correctly signed and significant at 1% level. Other three control variables (LEV, SIZE, BETA) are not statistically significant. The coefficient of determination indicates that about 7% of cost of debt variance is explained by the explanatory variables of the model.

## 5. Conclusion

This study aimed to show the relationship between CSR and cost of debt in TSE listed Iranian companies. According to the results of regression analysis for 65 firms in the period of 2008-2012, we did not find any significant impact of CSR on cost of debt. This result is not in line with the results of previous empirical papers, since these early works generally find a significant and negative relationship between social performance and cost of debt.

The concept of corporate social responsibility is quite new in Iran. Therefore, there are many other issues related to social responsibility can be examined in further research:

- The relationship between social responsibility disclosure and corporate returns.
- The relationship between social responsibility disclosure and stock price.
- The relationship between social responsibility disclosure and corporate governance and leadership.

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