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The perceived impact of corporate Social Responsibility on Credit Rating

M. Numan Nasir Butt [1]Ms Nadia Asghar[2]
[1]*(Management Sciences, Foundation University Institute of Engineering & Management Sciences, Pakistan)*

Abstract: *This paper looks at the importance of corporate social responsibility and what corporate social responsibilities have implications on the credit rating of a particular organization. The study will be focusing on what credit ratings are and what determines them. This will largely be studied in context to the Pakistani organization, both the national Pakistani companies and multinationals which are operating in Pakistan.*
Keywords– *Credit Rating, Corporate Social Responsibility, Pakistan*

I. Introduction

This section of the research report will be describing basically the aims to present to the reader the basics of what this report will later be focusing on. The introduction section will play the role of a foundation for the remaining report.

1.1 The need for a Holistic Financial Management

One of the reasons for specialization and the emergence, of various fields in the business management arena is in reflection of the competitive business world of today. Managers are trying to cover the business from each and every dimension so as to allow their organizations to have better success and stability. The same holds true for the financial manager of an organization. The job of the financial manager today is not just limited to the handling of costs and revenues of the organization and in the management of the assets (monetary and physical) and liabilities (monetary and goods). The job of the financial managers, with the increase and intensification of the financial integration of the world now is concerned with the management of the relationship that the organization has with its shareholders, suppliers, financers, customers and creditors. In this again, the finance manager of the business needs to manage the business in collaboration with the risk manager, the relationship manager and the asset liability manager of the organization. The idea is that the departments need to work in such a way so as to provide a synergy in all the functional areas. Finances of the business this means then need to be handled in a holistic manner.

One aspect of this holistic financial and business management is that due consideration be placed on the corporate social responsibility of the organization. The idea here is in no way humanitarian or philanthropist rather, it is solely based on the strategic and profitability implications of the organization. Literature on finance is full of the share price and bond value of the organization is one of the most important and commonly used ways of analyzing the intrinsic value of that organization. Management then, is all about increasing the value of the business and therefore, the notion of or the measure of value that the share price and bond value shows is an important consideration for the overall management of the organization. For the finance side however, it is more important because the share price and bond value defines the value of equity that the organization has at a fair market value. This also determines the amount of funds that a public offering by the organization will generate. For the purposes of further expansion of the business then and also for dealing with the liabilities of the organization, the funds generated and thus the share price and bond value of the organization is of utmost importance to the financial managers.

1.2 Company Value and Credit Ratings

An interesting aspect here, which again appeals to the holistic financial management, is that of the credit ratings and how they impact the share price and bond value of the organization. As will be noted later in this report, the credit ratings are reflective of the internal economic and financial strength of the company and on its ability to deal with the internal and external risk, opportunities and threats. There may be people (investors) who consider credit rating organizations to be politicized and therefore the rating to organization after looking at their credit ratings.

Now the credit ratings are impacted by *all* the aspects of business i.e. of the human resource and financial strength (including measures like high employee turnover or high rate of change of important executives), environmental disasters for example pollution through the operations or mismanagement of the organization, brand name mistakes for example linking with a bad reputed supplier, decrease in the quality of the product or a launch of a poorly developed product or involvement in a lawsuits. One of the most important

examples of how share prices and credit ratings can be affected is that of British Petroleum. After the Mexico Gulf oil spill, the British Petroleum saw a major slash in its credit ratings. According to Guardian (2010), the credits ratings were cut from AA to BBB by Fitch and that the case was worsened because of the compensations that were demanded of the organization. So much so that the dividends of the organization were expected to be cut. According to Guardian (2010), this downgrade made the borrowing for the organization to get more expensive (through an increase in the costs of loans offered by financial institutions to the organization). At the same time, Independent (2010) noted that that over 8 billion pounds of value was wiped off from the oil retailing giant, British Petroleum because of its mistake related to the corporate social responsibility. The stock according to the Independent (2010) fell by 11 percent and was expected to fall even more. So much so that people stopped going to the retail store of the organization, BP connect in reaction to the disaster caused to by the organization to the environment. This obviously made the issue of solving the case of the oil spill and paying the claimants more difficult but this was precisely how the customers and investors reacted, the bubble of which grew to a humongous size because of the presence and impact of speculations.

The point that being that, whatever the company does, even the slightest action that is, has an impact on the credit positioning and the share prices of the organization and therefore, the organization needs to be vigilant about each and every element that is related to its presence, thus a holistic management.

II. Theoretical Framework

What this research wants to study then is how the actions taken by the organization for its corporate social responsibility affect the credit positioning of the organization. The study will be focusing on what credit ratings are and what determines them. Furthermore, the research will focus on how the adoption and the practical actions related to corporate social responsibility impact the credit ratings of the organization. This will largely be studied in context to the Pakistani organization, both the national Pakistani companies and multinationals which are operating in Pakistan.

The aim of the research is to bring to the fore front, an important aspect of management of companies, which impact directly the costs and finances that the organization faces and thus to aid the businesses in Pakistan to improve their costs of expansion and costs of funds through the way of a better corporate personality in the market. The method for the purpose of doing this will be an in depth review of secondary data and a questionnaire survey to evaluate the performance of businesses regarding the impact of their corporate responsibilities and credit ratings.

A critical evaluation of the literature available on the issue will be presented and discussed to draw conclusions as to how the adoption and the various practices of corporate social responsibility impact upon the credit ratings of the organization. The research after critically discussing and inferring from the available information, applies the findings on why most of the organization in Pakistan have been rated with a D or a BBB even by PACRA (2012) and why internationally, Pakistani bonds are famous for being junk category bonds. The analysis will prove how developing approaches for better corporate social responsibility, will enable the credit ratings to improve.

For the questionnaire survey, a sample of 50 organizations in Pakistan was selected. The representative of the organization chosen was the corporate social responsibility of the organization and in the absence of the CSR manager, the marketing manager was asked to fill the questionnaire. The questionnaire sought to see the impact of CSR on the credit ratings of the organization. For this, the CSR initiatives were divided into three sections of service and were linked to the credit ratings and credit positioning of the organization. The results of the questionnaire were analyzed through correlation analysis.

2.1 Corporate Social Responsibility and Organization's Value

Goss and Roberts (2010) emphasize on the fact that the theme of corporate social responsibility has become one of the most dominant ones on the business management. Those who argue for a better management of the corporate social responsibility say that the investment in organization can be best view from a risk management perspective in that a organization choosing to act irresponsibly are actually externalizing a part of their cost of product which in other circumstances would have been visible in their expenses and costs. This means that sooner or later the costs of a socially irresponsible firm will be coming back to it and then the investors of the organization will be worse off. Through the research that Goss and Roberts (2010) conduct, it has been noted that lenders are typically more sensitive to the CSR role of a firm when proper security levels are absent from the market e.g. in the absence of a law that will enable the lender to retrieve the funds.

Apart from just the lender, it has been found that even the brand evaluations of the customers are impacted upon by the level of corporate social responsibility that the organization is practicing (Klein and Dawar, 2003). In fact, Klein and Dawar (2003, p. 203) say that corporate social responsibility impacts upon the consumer perceptions through the following two ways

"(1) CSR plays a role in consumers' brand and product evaluations, over and above economic or 'rational' considerations such as product attributes; and (2) CSR has a spillover or 'halo effect' on otherwise unrelated consumer judgments, such as the evaluation of new products."

The question however is why consumer perceptions are important for a research that is originally looking at the credit worthiness of an organization. The simple reason (also as can be seen through the example of British Petroleum) is that the customers generate revenue for the organization which apart from the debt and the equity is a important source of funds for the organization, so important that a fall in sales is probably considered to be the worst thing that can happen to an ongoing concern. So basically, if the organization declines in its revenue generations, then that credit ratings will automatically fall because technically the organization will not have the funds enough to satisfy its loans. Now because the CSR practices of the organization impact upon the customer perceptions and then the practices of the customer impact upon the credit ratings of the organization, it is considered that if the organization is to maintain effective credit rating, the focus on CSR should be established, developed and maintained. Kim and Lee (2011) however say that sometimes consumers are unable to properly figure out the corporate social responsibility motives of the organization. The contradiction that they face is between the firm serving and society serving organization and it has been found that as far as the consumers and their brand evaluations are concerned, the perception of what the firm is doing is actually more important than what the firm is actually doing.

Apart from the consumer perception value of the organization, Linthicum, Reitenga and Sanchez (2010) note two aspects of corporate social responsibility. On one end they note the proponents of corporate social responsibility especially Chaney and Philipich (2002) that reputation of the organization precedes its actual operations and that this reputation significantly affects the investor decisions. The case discussed by Linthicum, Reitenga and Sanchez (2010) is that of Arthur Andersen, when the organization suffered from abnormal returns once the case of Enron audit was brought into the limelight. The issue with the existence of corporate social responsibility then again is that it is a business element under significant debate. The detractors of corporate social responsibility say that it is in fact a wasteful spending of precious shareholders money which should be spent on profitable activities to maximize the return of the shareholders wealth (Atkins, 2006). On the other hand, the proponents say that it builds goodwill which in itself is a gain in the wealth of the shareholder. Another aspect of this is that the shareholders themselves seek to invest in organizations which are socially more responsible because they consider their investments as being socially responsible (Baue, 2002) and (O'Brien, 2002). The investors in this think that by orienting their wealth correctly, they are in fact fulfilling their social, environmental and ethical responsibility (Statman, 2000).

2.2 Corporate Social responsibility and Financial Performance

There is a significant amount of literature available on social performance of the organization and its link with the financial performance of the organization. The results however have been mixed regarding the impact that exists of the former on the latter (Salzmann et al, 2005). The techniques for analysis most commonly used are portfolio studies comparison (or socially reactive and proactive organizations), event studies (post CSR market responses) and multiple regression studies (Wagner et al, 2001). For example, it has been noted by Aupperle et al (1985) that social activities are costly for the organization and thus through the route of loss of efficiency, put the firm at an economic disadvantage as compared to those organization which are less socially responsible. The basic idea in this case is that the only thing the management of a capitalist organization should be responsible for are the returns of the shareholders. This view of declining returns has also been supported by Wood (1992) whereas Bauer et al (2005) find that there is no relationship between the financial performance of the organization and its social performance. In terms of an effective investment and return framework, Knox and Maklan (2004) emphasize on the lacking of CSR that thedre is absence of reliable systematic framework that links responsibilities to the business (financial) or social outcomes. In this regards, Weber (2008) argues that there needs to be further research on how to measure the *company specific* values of CSR activities.

Statman (2000) is also one of those who find no statistical relationship between the two variables however say that investors psychologically feel attracted towards socially responsible firms which then helps the financial value of the firm.

On the brighter side however, findings of Schueth (2003) and Diltz et al (1999) support those of Statman (2000) in saying that it is more the behavior and attitude of the investors towards the organization which lead to increase in the stock value of the more responsible organization.

2.3 Corporate Social Responsibility and Cost of Capital

Ghoul et al (2011) study whether the corporate social responsibility of a firm effects the cost of capital, both equity and debt. As expected then, the research results show that companies which have a better score with corporate social responsibility actually are able to exhibit a cheaper financing then those organizations which do not. The research also finds that even though the organization through CSR may not be able to increase the

present value of the organization, but would most likely be able to maximize the market value (Mackey, Mackey and Barney, 2007) This means that the investment in improving the organization's relationship with its employees, society and environment actually help the organization in getting cheaper financing. It has to be noted that better credit rating also enable the organization to get cheaper sources of financing. This basically means that the two need to be considered in alignment if an organization has to lower its costs of capital. The same is found to be true for the internal stability of the organization through operational performance and the external quality of the organization (firm performance) (Parast and Adams, 2011). The authors argue that companies who adopt a better level of corporate social responsibility actually are able to score better on these two measures as well.

2.4 Credit Ratings and Their Impact

According to Christian (2009), a credit rating basically evaluate the credit worthiness or the ability of a debtor to pay of the loans. This holds most importantly in the case of a business (limited organization) or a government (which issues bonds). This evaluation is made by a formal credit rating agency and in the process of doing so, the ability of the debtor and also the likelihood of the debt being paid is vigilantly observed. According to Christian (2009), credit rating even though is done through both qualitative and quantitative means, it is not entirely based on mathematical formulas. Rather, the agencies responsible for the ratings, establish the rating through their experience and judgment considering the information available, the position of the entity being rated and the expected future of the entity. The most important use of a credit rating is for those who seek to invest in bonds that have been issued by organizations and government. Basically, a poor credit rating, or a junk category investment depicts that the credit rating agency thinks that the concerned government or company has a significantly high risk of defaulting and thus not paying the value of the bond back to the investors let alone allow for capital gains.

Servigny, Renault and Renault (2004) mention that the credit ratings are being done importantly by Dun & Bradstreet, Moody's, Fitch Rating and Standard & Poor's. Each of them follows their own scale using the alphabets A, B and C. In Pakistan then, this job of credit rating is done by PACRA, or Pakistan Credit Rating Agency (PACRA, 2012). Even though these ratings form important notion for potential financers of a government or a corporation as to whether investment should be done in them or not, Duff and Einig (2008) note that during the economic and financial recession of 2008, and especially the subprime mortgage crisis in the 2007, the quality of the information that these credit rating agencies actually provided was placed under significant scrutiny. In fact, according to the authors, Duff and Einig (2008), some analysts and politicians have actually expressed that the financial instability that the world is facing today has been somewhere stimulated by the Credit Rating Agencies. In that then, it has also been argued that very little academic research is available on the issue of the quality of rating that the credit rating agencies provide. What Duff and Einig (2009) propose as a solution to this problem is a measurement instrument that would allow the user to capture the quality of the ratings that are provided *"among four stakeholder groups in the public debt markets"*. The following method is used by the researchers for the construction of this metric (Duff and Einig, 2008, p. 141),

"Two macro-constructs of ratings quality are identified, labeled Technical Qualities and Relationship Qualities. The two macro-constructs are measured by ten micro-attributes, labeled: Cooperation; Independence; Internal Processes; Issuer Orientation; Methodology; Reputation; Service Quality; Shared Values and Norms; Transparency; and Trust. Each micro-attribute is operationalized into individual items, and then empirically tested using data obtained from issuers, non-debt issuing financial managers, investors, and other interested parties."

Furthermore, as far as the issue of credit ratings is concerned, Heflin, Shaw and Wild (2011) say that the credit rating quality in relation to the credit worthiness of a particular organization depends on the number of annual and quarterly disclosures that the organization does. Meaning simply that, the quality of the credit rating is dependent upon the level of information that is available, the more the information available, and the more the chances of a better credit rating. Nonetheless, Becker and Milbourn (2011) say that previously the field of credit rating was dominated by Moody's and Standard and Poor's however now with the increased competition in the rating agency industry, the quality of the ratings have significantly gone up.

III. Research Findings

	Community Service	**Employee Service**	**customer service**	**credit position**
Community Service	-0.052 (0.719)			
Employee Service	0.458 (0.001)	0.045 (0.755)		
customer service	0.281 (0.048)	0.221 (0.122)	0.576 (0.000)	0.023 (.0873)
credit position	0.021 (0.887)	0.193 (0.180)	0.017 (0.905)	

The most important result is the relationships between credit position with community service, employee service and customer service. According to the results however, corporate social responsibility in any of the dimensions is not seen to have a strong relationship with the credit ratings in the Pakistani market. The results are seen to be in alignment with the school of thought which considers CSR to be a waste of precious shareholder money. In the case of Pakistani organizations, the credit ratings are not found to be influenced by the social initiatives of the businesses. This implies that as long as the financial position of the organization is not sound, the social position is not likely to have a very significant impact.

IV. Discussion and Conclusion

The research has basically seen the importance of relationship between corporate social responsibility and the credit ratings. It has been found that literature in this field is largely lacking and insufficient and even though indirect pointers to this relationship are present, there is very little research that directly studies the impact of corporate social responsibility of an organization on the credit ratings. Nonetheless, a significant degree of research has found to support the positive impact of CSR on share value (Beccehtti et al, 2012). One of the reasons for this is that the investors themselves want their investment to be socially more responsible. However in order to reach a better conclusion more research is required. Therefore an appeal is made for further research into this field. The research has further found that in the case of Pakistan, the stakeholders, especially the creditors are not influenced by the social initiatives of the organizations. The focus is not the financial performance. This is mostly because Pakistani organizations are still on the lower order needs whereas CSR is an issue more pressing in societies with higher order needs. The same holds true, strictly for the government of Pakistan. The conclusive solution for this is that security and the mass education in regards to corporate social responsibility be increased within the firms and also at a macro level. Apart from that, there needs to be growth in the rating industry itself so as to make sure that the ratings are reliable, competent and credible and more inclusive.

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