

Acknowledgment

First and foremost, I would like to thank God Almighty for giving me the strength, knowledge, ability and opportunity to undertake this research study and to persevere and complete it satisfactorily. Without his blessings, this achievement would not have been possible.

I would like to express my deepest gratitude and appreciation to **Professor Mohamed Sabry Nada**, my research supervisor who have been a tremendous mentor for me, for his patient guidance, enthusiastic encouragement, continuous inspiration and useful critiques to accomplish this work. Words can never be enough to thank him.

I would like to express my very great appreciation to **Dr. Mohamed Hassan Abdel Mageed**, my second supervisor for his valuable and constructive suggestions during the planning and development of this research work. His willingness to give his time so generously has been very much appreciated.

I would like also to express my deep thanks to **Professor Gamal Saad Khatab**, Professor of Accounting and Auditing Department- Faculty of Commerce – Ain Shams University, for accepting to be a committee member. Also, for his time, support and professionalism. I highly appreciate his participation.

I would also like to show my deepest gratitude to, **Professor Mahmoud El Said Mohamed El Feky**, Professor of Accounting Department -Faculty of Commerce -University of El Azhar, for agreeing to be part of the thesis defense committee and for his valuable time and professionalism.

Finally, I must express my very profound gratitude to my parents for providing me with unfailing support and continuous encouragement throughout my years of study and through the process of researching and writing this thesis. This accomplishment would not have been possible without them.

Dedication

This work is dedicated to

*My beloved Mum your prayers, tenderness & support
are the reasons of what I became today.*

Dad my backbone and the source of security & tranquility.

My Sister and Brother the source of joy & care.

Abstract

Measuring the Impact of Corporate Social Responsibility on Cost of Capital and Investment decisions “An Applied Study” - Master Thesis (2018)

This study aims to investigate whether corporate social responsibility (CSR) could increase firm value by lowering the cost of capital. In addition, the study aims to examine the mediating effect that cost of capital has on both CSR and investment decisions within corporations. Data is collected from the financial statements of the firms listed in the Egyptian Stock Exchange that appear in the Egyptian index of social responsibility (S&P/ESG) index between 2012 and 2016.

The results show an insignificant negative relationship between CSR and the Cost of Equity Capital obtained through accounting-based valuation models; thus implying that firms applying CSR have no impact on its cost of equity. However, the results show a significant negative relationship between CSR and cost of debt. This means that firms that adopt CSR practices suffer low COD. Furthermore, results show a significant negative relationship between CSR and WACC, which implies that CSR practices, lowers firms' overall cost of capital.

The applied study also revealed a significant negative relationship between COE and IRR proving that the firms' internal rate of return increases as its cost of equity decrease. Also, COD has a significant negative relationship on firms' risk premium showing that the when the cost of borrowing is increased the risk premium is decreased. Then, on testing the relationship between the CSR and investment decision using appropriate accounting measurements, which are IRR and RP. The results refer to a significant negative relationship between CSR and IRR contradicting the arguments that CSR practices should increase firms' IRR. Moreover, results show a significant negative relationship between CSR and RP proving that CSR practices mitigate firms' risk.

Finally, examining the relationship of CSR and investment decision in the presence of cost of capital (WACC) reveal a significant negative relationship between CSR, WACC and IRR. In addition, show an insignificant negative relationship between CSR, WACC and RP.

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List of Abbreviations:

CAPM	Capital Asset Pricing Model.
COC	Cost of Capital.
COE	Cost of Equity.
CRISIL	Credit Rating Information Services of India Limited.
CSR	Corporate Social Responsibility.
ECRC	Egyptian Corporate Responsibility Center.
EIoD	Egyptian Institute of Directors.
EPS	Earnings Per Share.
ESG Index	Environmental, Social and Governance index.
EU	European Union.
HR	Human Resource.
ICC	Implied Cost of Capital.
ID	Investment Decision.
ILO	International Labor Organization.
IRR	Internal Rate of Return.
MENA	Middle East & North Africa.
RI	Responsible Investment.
RRR	Required Rate of Return.
RP	Risk Premium.
S&P	Standards and Poor.
SRI	Social Responsible Investment.
UN PRI	United Nations initiative Principles for Responsible Investment.
VP	Vice President.
WACC	Weighted Average Cost of Capital.

Chapter One

Introduction

1.1. Introduction:

Over the past decades, there was a strong demand for corporations to engage in Corporate Social Responsibility (CSR) practices. In addition, the importance of CSR disclosure has grown massively to the extent that some corporations argue that it is necessary to issue separate CSR report, which include more details about the corporation's social and environmental activities in addition to its normal report.

The economist **Milton Friedman (1970)** was the one to generate the contentious debate over the modern relevance of corporate social responsibility. He argued that public companies possess only minimal ethical obligations (e.g., to operate within the societal ethical frame, to avoid deception and fraud) beyond maximizing profits and obeying the law. In contrast, business ethicists often discuss the essential role of multiple interests in the decision-making process of effective managers. Additionally, **Goolsby and Hunt (1992) & Carroll (1999)** studied the positive impact of moral reasoning on the performance of managers and employees who have boundary-spanning occupations.

According to **Dhaliwal (2011)**, Firms with superior CSR performance are more likely to publicly disclose their CSR practices and plans by issuing sustainability reports. Also; they may depend on reports provided by third parties for increasing the credibility of such reports.

CSR reporting creates a positive feedback loop: a) increases transparency around the social and environmental impact of companies, and their governance structure and b) may change the internal control system that further improves the compliance with regulations and the reliability of reporting. (2) Therefore, CSR reporting results in decreasing information asymmetry which in turn influence financing costs.

Many previous researches such as **Waddock and Graves (1997)**, **McWilliams and Siegel (2000) & Orlitzky et al. (2003)** investigated the relationship between corporate social performance to both accounting-based and market-based measures with mixed results. **Dhaliwal et al (2011)**, **El Ghoul et al. (2011) & Cheng et al. (2014)** findings have given rise to new research to gain understanding of the relationship between CSR and financial performance from the capital market participants' perceptions of CSR.

Sharfman and Fernando (2008) and El Ghoul et al. (2011) show that a good CSR performance decreases the cost of capital, because of a reduction of a firm's risk and a larger firm's investor base. For their part, **Dhaliwal et al. (2011)** indicates that firms with a good CSR performance reduce information asymmetry. If there are numerous and recent evidence of financial consequences of the increasing attention on corporate social responsibility from investors, few studies analyze the effect of CSR performance on firms' financial policies. But, if we consider that CSR performance has a negative impact on cost of equity and reduces information asymmetry, socially responsible firms would have more advantages than others to issue equity, and would be less leveraged. Therefore, our work investigates whether firms adapt their financing decisions according to their CSR performance.

El Ghoul et al. (2011) show that firms with high CSR performance have lower cost of equity capital. They argue that decreased information asymmetry is one of the channels through which CSR affects the cost of equity capital, as investors perceive less risk. Consequently, **Dhaliwal et al., (2011)** argued that voluntary CSR disclosure decreases information asymmetry and therefore lowers the firm's cost of equity capital.

"In the last decades, a growing number of investors incorporate environmental and social considerations into their investment decisions" **El Ghoul et al. (2011)**. The increasing attention on corporate social responsibility (CSR) from investors has raised the question of its financial impact. In the academic literature, there are many arguments, which support that CSR performance would have an impact on firms' market value. **Waddock and Graves (1997)** noticed that from a theoretical point of view, a good CSR performance might increase productivity and financial performance because it implies a good relation with key firm's stakeholders through meeting stakeholders' expectations. **Fombrun et al. (2000), McWilliams and Siegel (2001)** induced by the increasing awareness about CSR, firms generate a reputational capital and enhance their social legitimacy, which can contribute to ameliorate sales and to increase customers' loyalty. Following these work, which tend to prove that information about CSR performance matters for stock market investors, several authors have studied financial consequences of this increasing integration of information about CSR performance in investment decision-making.

Phillip's report (2014) revealed that the United Nations initiative Principles for Responsible Investment (UN PRI) was launched in 2006 as a framework instructing incorporation of environmental, social and governance issues into investment analyses and decision-making processes. In addition, *Eurosif (2014)* noted that as of June 2014, 38 asset owners, investment managers and professional services partners in Sweden had signed the UN PRI. These are signs of how social responsibility is developing into a natural part of investment decisions.

1.2. Research Problem:

Firms that do not undergo social and environmental aspects in their operating activities may face many problems (lawsuits and breaching law rules and regulations...). Consequently, firm's reputation is damaged losing stakeholders' trust, leading to a decreased investors' base and thereby affecting firms' value.

The increasing demand for adopting CSR and exploring its positive impact on the firm's performance leading to a better market share and boosting firm's overall values also encourages the researcher to test CSR practices in the Egyptian market and measure its influence on the firm's funding costs.

Examining the relationship between CSR and the cost of capital can consequently help managers comprehend the effect of CSR investments on firms' financing costs.

Many researches called for exploring the role of capital markets as an intermediate mechanism through which CSR can create long-term value. Also, they called for examining how CSR influences firm's cost of capital in a direct way.

Thus, the researcher can summarize the research problem in that Irresponsible Performance may lead to: 1- Increased firms' Risks 2- Information Asymmetry 3- Deterioration of Companies' Image and Value. Therefore, adopting social responsible practices leads to cost savings, affects the financial results of a firm and thereby its investment decisions. Thus, cost of capital can act as a channel that encourages corporations to enhance their social responsibility through affecting its investment decisions.