Unconditional Conservatism and Capital Cost: Explaining the Role of Corporate Social Responsibility

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Abstract

Objectives: This study aims to investigate the effect of unconditional conservatism on capital cost, considering the role of corporate social responsibility. The research seeks to understand how these factors interact and influence the overall cost of capital for firms.

Methodology/Design/Approach: To achieve this purpose, the modified model by Givoly and Hayn (2000) was employed to calculate unconditional conservatism, following the methodologies of previous studies such as Krishnan and Viswanathan (2008) and Ahmed and Dolman (2007). This model emphasizes the estimation of unconstrained conservatism based on standardized accruals relative to total assets (TA). The criteria used to measure corporate social responsibility were adapted from Anis and Utah (2016). Data were collected from a sample of 102 firms listed on the Tehran Stock Exchange over five years from 2018 to 2022. Multivariate regression analysis of panel data was utilized for data analysis.

Findings: The results of the hypothesis testing revealed that social responsibility has a negative and significant effect on corporate capital cost, while unconditional conservatism does not exhibit a significant effect on the cost of capital. Additionally, a positive and significant relationship was found between unconditional conservatism and social responsibility.

Innovation: This research contributes to the existing literature by exploring the interplay between unconditional conservatism, corporate social responsibility, and capital costs within the context of Iranian firms. It highlights the importance of understanding how social responsibility initiatives can influence financial metrics, thereby providing practical insights for managers aiming to optimize capital costs through enhanced corporate governance practices.

Keywords: Unconstrained Conservatism, Cost of Capital, Corporate Social Responsibility.

1. Introduction

Basu (1997) defines accounting conservatism as "the tendency to require a higher degree of verification to recognize good news as gains than to recognize bad news as losses," emphasizing asymmetry in the recognition and verification of financial outcomes. This asymmetry implies that losses are recognized more readily than gains, reflecting a cautious approach to financial reporting. The practical implication of conservatism is that financial statement information becomes more prudent, which can influence the usefulness of financial statements in capital markets. Specifically, conservatism affects the relevance of financial information for investors attempting to assess a firm's fundamental value, as overly conservative reporting may delay the recognition of gains while highlighting losses, thereby affecting stock prices and investment decisions (Remco Polman, 2007; Watts, 2003).

Accounting conservatism is typically distinguished into conditional and unconditional forms. Conditional conservatism, or asymmetric timeliness, recognizes losses promptly when adverse events occur but defers the recognition of gains until they are realized. This approach is commonly applied through accounting rules such as the lower-of-cost-or-market method for inventories or immediate expensing of tangible asset repairs. Unconditional conservatism, also referred to as balance sheet conservatism, emphasizes a systematic understatement of net asset values regardless of current economic events, ensuring that book values remain prudently conservative over time. Both forms of conservatism aim to reduce the risk of overstatement in financial reporting, though they operate through different mechanisms (Hashemi et al., 2011).

The degree of conservatism in financial reporting has implications for a firm's cost of capital, defined as the discount rate used by investors to convert expected future earnings into present value. Investors, including both creditors and shareholders, require returns commensurate with the risk associated with their investment (Khani, 2012). Firms that adopt conservative accounting practices may reduce informational risk, improve transparency, and signal prudence to investors, thereby lowering the perceived risk of investment and ultimately reducing the cost of capital. Conversely, excessive conservatism may limit the timeliness of gain recognition, potentially affecting investment valuation and firm attractiveness in capital markets. Additionally, corporate social activities and responsible behavior can mitigate societal friction, reduce operational and reputational risks, and further decrease the firm's cost of capital, enhancing overall corporate value (Hajiha et al., 2014).

In sum, accounting conservatism, whether conditional or unconditional, serves as a critical mechanism for risk mitigation in financial reporting. By influencing investors' perceptions and the firm's cost of capital, conservatism interacts with corporate strategies, including social responsibility initiatives, to enhance transparency, reduce financial and operational risk, and support sustainable value creation.

2. Literature Review

Uncertainty and ambiguity are inherent in all aspects of human decision-making, including financial reporting, where ambiguities arise in recognizing and measuring economic events such as debt collection, asset-based income generation, and contingent liabilities. Accounting conservatism, or the prudence principle, addresses these uncertainties by requiring that potential losses be recognized promptly while gains are deferred until realized, providing more reliable and cautious financial information (Setayesh & Jamalian, 2010; Schroeder et al., 2008). Watts (2003) identifies four economic factors shaping conservatism: contracting, litigation, regulation, and taxation. The contracting view posits that conservatism mitigates moral hazard from asymmetric information between managers and stakeholders. By delaying the recognition of gains and emphasizing verifiability, conservatism limits opportunistic managerial behavior, aligns shareholder expectations, and reduces the cost of equity capital (Pourzamani & Mansouri, 2014). Conservatism can be conditional (news-dependent, ex

post) or unconditional (balance-sheet-oriented, ex ante). Conditional conservatism reflects asymmetric recognition of gains and losses based on observable economic events, whereas unconditional conservatism emphasizes prudence regardless of news, such as accelerated depreciation or immediate expensing of R&D costs (Basu, 2005; Qing, 2007; Ise, 2002). Evidence shows that unconditional conservatism enhances financial reporting credibility, facilitating credit access and reducing capital costs (Ishida, 2014; Kenneth, 2022; Zahir, 2019). Conditional conservatism can serve as a credibility mechanism for managers of R&D-intensive firms when forecasting earnings under uncertainty (Kanan, 2023).

Corporate social responsibility (CSR) represents an organization's commitment to ethical principles, environmental stewardship, and social well-being alongside economic objectives (McKenney, 2008; Tucker, 2009). CSR practices influence stakeholders' perceptions, impacting corporate value and financial policies. Research demonstrates that firms with stronger CSR engagement experience lower capital costs, reduced financial risk, and higher firm value (Harjoto & Lakshmana, 2016; Larosa et al., 2017; Lee & Liu, 2017). Studies also examine the interaction between CSR and conservatism. KANGARLOUEI et al. (2010) found a significant positive relationship between CSR and conservatism in firms listed on the Tehran Stock Exchange, indicating that ethical behavior aligns with prudent financial reporting. Hashemi et al. (2011) showed that conditional conservatism inversely relates to the cost of equity capital, suggesting that higher conservatism reduces financing costs. Similarly, corporate disclosure of CSR information enhances transparency, providing decision-useful information for investors (Hajiha et al., 2014; Pourali, 2014; Arab Salehi et al., 2013).

Empirical studies confirm the influence of conservatism and CSR on various financial and operational outcomes. Zalghi and Bayat (2016) observed that both conditional and unconditional conservatism reduce systematic risk, highlighting the stabilizing role of reliable financial reporting. Keravat

(2012) found that conservative accounting reduces managers' inclination toward high-risk investments. Ton (2013) reported increased conservatism when lenders are actively involved in financing decisions. Saros and Tomayo (2013) indicated that CSR positively affects firm value, especially in companies with higher public or customer awareness. Badavar Nahandi et al. (2014) and Moradi et al. (2014) confirmed that CSR enhances performance and market value by optimizing capital allocation and working capital strategies. Hajiha et al. (2014) and Lee & Liu (2017) concluded that improved CSR disclosure reduces equity and debt costs, particularly for larger or environmentally sensitive firms. In Iran, Mohammadi (2012) and Pourali (2014) highlighted limited CSR implementation due to insufficient public awareness and corporate knowledge, while Arab Salehi et al. (2013) emphasized the positive relationship between CSR and financial performance in TSE-listed firms.

Studies also indicate that conservatism improves the credibility and quality of financial reporting, enhancing the willingness of banks and financial institutions to extend credit (Ishida, 2014). Hamdan (2012) reported that larger firms exhibit higher conservatism than smaller firms, while highly leveraged firms adopt more conservative practices. Research by Saros & Tomayo (2013) and Harjoto & Lakshmana (2016) suggests that CSR acts as a mechanism to control excessive risk-taking, balance stakeholder interests, and increase firm value. Zalghi and Bayat (2016) found a negative relationship between conservatism and systematic risk, supporting the role of reliable reporting in stabilizing firm operations. Arab Salehi et al. (2013), Pourali (2014), and Hajiha et al. (2014) collectively demonstrate that CSR disclosure and responsible corporate behavior reduce financing costs, enhance transparency, and strengthen investor confidence.

Overall, accounting conservatism and CSR function as complementary mechanisms that improve financial reporting reliability, reduce managerial opportunism, enhance stakeholder trust, and positively influence firm value and risk management.

Conservatism provides a safeguard against overstatement of earnings and assets, while CSR promotes ethical, social, and environmental accountability, collectively contributing to the long-term sustainability and credibility of firms.

3. Research Variables

3.1. Unconditional conservatism

The unconditional conservatism, known as news-dependent or ex post conservatism, refers to those accounting standards that reduce profit independently of current economic news. Under unconditional conservatism, the book value of net assets decreases below the expected value through predetermined accounting procedures (Kordestani, 2012). One of the non-conditional conservative estimation criteria is the Beaver and Ryan (2000) model. This model emphasizes the stock market value more. Versions of this model are considered in studies such as Lara et al. (2007) and Ahmad Dolman (2007). According to Asadi and Jalalian (2012), the following formula will be used to calculate non-conditional conservatism. (Izadinia, 2013).

Unconditional conservatism

$$= \frac{\text{Book value of equity}}{\text{Market value of equity}} \times -1$$

3.2. Capital cost

Each company has its own risk and return. Each group of investors, such as holders of bonds, blue-chip stocks, and common stocks, seeks a rate of return that is appropriate for it. The cost of capital is defined as "the minimum return that a company should obtain to provide the desired returns for investors in the company." The following formula is used to calculate the cost of capital:

WACC= (Kb *(1-Tc)*D/ V) + (KS*S/V)

WACC: The cost of capital of the company at time t
S: (equity (reflecting the equity by the end of the year
D: total debt

V: The value of the company, which is derived from the total value of debt and equity.
Kb: Loan Rate: Financial costs (from the income statement divided by total debt)
Tc: Tax Effect: Tax Costs (from the income statement divided by pre-tax earnings1).
KS: is the adjusted realized return, the capital provided by the shareholders (Valipour et al., 2011).

3.3. Corporate social responsibility

51 indicators are used based on corporate social responsibility disclosure to investigate the level of corporate social responsibility disclosure (Barzegar, 2013) and Anis and Atama (2016). These indicators have arisen in two social and environmental dimensions, each of which has a series of components. The content analysis of the annual report is made by the corporate board of directors to measure the percentage of corporate social responsibility disclosure. Thus, the number 1 is given if each of the proposed indicators is disclosed, and otherwise the number zero is given (Ernst Varnst, 1978; Abbott Wumansen, 1979; Anis and Utma, 2016), and then the percentage of disclosure of each social responsibility of companies is calculated.

3.4. Firm size

The bank size is measured by the total assessment of the bank's assets, and the importance of the bank size is due to its relationship with the ownership structure and access to stock capital. Bank access to stock capital can increase the bank's flexibility against bankruptcy costs; therefore, larger banks need fewer capital requirements due to easier access to capital markets and having more diverse portfolios. As a result, the capital adequacy ratio 2increases by

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[1] Pretax earnings are a company's income after all operating expenses, including interest and depreciation, have been deducted from total sales or revenues, but before income taxes have been subtracted. ... Also known as pretax income or earnings before tax (EBT).
[2] Capital Adequacy Ratio (CAR), also known as Capital to Risk (Weighted) Assets Ratio (CRAR), is the ratio of a

increasing the bank size; therefore, there is a positive relationship between the bank size, including total assets, and the capital adequacy ratio.

3.5. Return on equity (ROE)3

This variable is a measure of the profitability of a company using the resources provided by shareholders. The net profit and average equity are used to calculate this ratio. This ratio can be used to calculate the bank's earnings per one rial of equity. In such a way that the profit after tax is divided by equity, and using the return on equity, the relationship between earnings and equity is determined. Long-term deposits, short-term deposits, and savings increase shareholders' wealth when the return on investment is more than the interest rate on deposits.

3.6. Return on assets 4(ROA)

The return on assets refers to effective management in relation to the use of assets in order to generate profit, which is calculated by dividing the annual profit by the total assets of the company. This ratio relates the ratio of operating profits to all resources managed by the bank. This ratio is considered one of the most important ratios to evaluate the efficiency and management ability, and it evaluates the net income generated by the use of all bank assets.

3.7. Financial leverage (LEV)

The financial leverage represents a percentage of the debts that are covered by capital. This variable is used by companies to increase returns on equity. Increasing the use of financial leverage increases the risk

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bank's capital to its risk. ... The enforcement of regulated levels of this ratio is intended to protect depositors and promote stability and efficiency of financial systems around the world.
[3] In corporate finance, the return on equity (ROE) is a measure of the profitability of a business in relation to the book value of shareholder equity, also known as net assets or assets minus liabilities. ROE is a measure of how well a company uses investments to generate earnings growth.
[4] The *return on assets* (*ROA*) shows the percentage of how profitable a company's assets are in generating revenue.

involved; therefore, higher capital requirements will be generated.

4. Research Hypotheses

Hypothesis 1: Unconditional conservatism has a significant positive effect on the corporate capital cost.
Hypothesis 2: Social responsibility has a significant negative effect on the corporate capital cost.
Hypothesis 3: Unconditional conservatism has a significant positive impact on corporate social responsibility.

5. Methodology

This study seeks to answer the question, "How does unconstrained conservatism affect capital cost by emphasizing the mediating role of social responsibility?" Therefore, the present research is considered an empirical study and is considered a descriptive study based on regression analysis in terms of data collection, although it is considered an applied study in terms of purpose.

The statistical population of the present study includes the companies listed on the Tehran Stock Exchange (TSE). From 2018 to 2022, the stock of these companies has been actively traded on the stock exchange. The limited sampling method was used. The criteria are as follows:

1) Before 2012, they were listed on the stock exchange and were active on the stock exchange until the end of 2016, and were not unprofitable.

2) To achieve comparable information, these companies have not changed financial periods during the period studied, and the end of their fiscal year is Esfand 29.

3) To achieve homogeneous information, they shouldn't be among the investment companies or financial intermediaries, including insurance and banks.

4) Their financial information should be available on the stock exchange site.

According to the limitations imposed and defined, 102 companies were selected as the final sample; therefore, the total data studied was 502 cases (year-company).

First, the library method (from books, specialized Persian journals, Latin papers, articles, and theses) was used for theoretical topics and relevant literature. Then the collected data were entered and classified in a spreadsheet, and EVIEWS software was used for econometric analysis and necessary estimates. Finally, the analysis was carried out using the common statistical indicators and the results of the estimation.

The regression analysis and correlation were used to test the research hypotheses. The F test, T test, determination coefficient, correlation coefficient, and Durbin Watson test were used to measure the significance of the patterns. The panel data method has been used due to the type of data and available statistical methods. Panel data covers the past trends of variables and ensures the dynamics of variables. The models used in this study are based on the base article.[5] As follows:

$$COD_{it} = \beta_0 + \beta_1 CONSV_{it} + \beta_2 CSRD_{it} + \beta_3 EBIT_{it} + \beta_4 MBA_{it} + \beta_5 LEV_{it} + \beta_6 SIZE_{it} + \beta_7 ROA_{it} + \beta_8 ROE_{it} + \beta_9 AGE_{it} + \varepsilon_{it}$$

$$CSRD_{it} = \beta_0 + \beta_1 CONSV_{it} + \beta_2 EBIT_{it} + \beta_3 MBA_{it} + \beta_4 LEV_{it} + \beta_5 SIZE_{it} + \beta_6 ROA_{it} + \beta_7 ROE_{it} + \beta_8 AGE_{it} + \varepsilon_{it}$$

6. Results

In order to perform the tests and select the appropriate model of the panel data patterns, for the homogeneity test, firstly, the model was estimated in the form of two methods of common coefficients and coefficients with constant effects. According to the F-statistic, the random effects model was selected to test the hypotheses of the research in both models.

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[5] Idrianita Anis a, Sidharta Utama (2016), The effect of conditional conservatism on cost of debt and mediation role of CSR disclosure: Empirical evidence from IDX.

In this section, regression and panel data models were used to evaluate the results of each of the hypotheses. Finally, the overall result for each model is estimated. Table 1 shows the results of the first and second hypotheses testing.

In investigating the significance of the whole model, given that the probability of F-statistics is smaller than 0.05 (0.000), at the confidence level of 95%, the significance of the whole model is confirmed. The coefficient of determination of the model also indicates that 29.03% of corporate social responsibility changes are explained by the variables entered in the model. In investigating the significance of coefficients in the third hypothesis testing, according to the results presented in Table 2, at an error level of less than 5%, there is a significant relationship between unconditional conservatism and the corporate social responsibility disclosure. As a result, the relationship between unconstrained conservatism and corporate social responsibility disclosure at a confidence level of 95% is confirmed, and according to the obtained coefficient, 0.66, which indicates the direct relationship between the two variables, as a result, at a confidence level of 95%, it can be claimed that there is a positive and significant relationship between unconditional conservatism and the corporate social responsibility disclosure; thus, the third hypothesis is confirmed. The Durbin-Watson statistic (1.66) represents the lack of self-correlation between independent variables, and the homogeneity of variance test indicates that there is heterogeneity of variance in components in different studies, which has been resolved using the EGLS method.

The results of the third hypothesis test are presented in Table 2.

Finally, according to the control variables test, there is a positive and significant correlation between pre-tax profit and tax with corporate social responsibility disclosure, and it also showed that there is an inverse relationship between the variables of market-to-book and company size with the corporate social responsibility disclosure.

Table 1: Results of the first and second hypothesis testing

Variable	Estimated coefficient	standard error	The t-statistics	P-value
y-intercep	0.590515	0.173631	3.400986	0.0007
Unconditional conservatism	0.122593	0.189072	0.648392	0.5168
Disclosure of corporate social responsibility	-0.157375	0.044291	-3.553234	0.0004
Profit before interest and taxes	0.095320	0.023068	4.132129	0.0000
Financial Leverage	0.133543	0.054547	2.448212	0.0000
Market value to book value	-0.001935	0.002682	-0.721489	0.4707
Return on investment	-0.358997	0.137410	-2.612592	0.0090
Return on equity	-0.475082	0.111811	-4.248960	0.0000
Company size	-0.146496	0.039239	-3.733436	0.0002
Company age	0.015222	0.005481	2.777411	0.0055
Coefficient of determination 0.242		Adjusted coefficient of determination: 0.239		
Durbin-Watson Statistics 2.16		The F-statistic is 12.374	probability of F statistics 0.000	

Table 2: Results of the third hypothesis testing of the research

Variable	Estimated coefficient	standard error	The t-statistics	P-value
y-intercep	0.466807	0.221153	2.110795	0.0349
Conditional conservatism	0.668628	0.262687	2.545341	0.0454
Profit before interest and taxes	0.110070	0.033441	3.291462	0.0010
Financial Leverage	0.149919	0.197161	0.760391	0.4471
Market value to book value	-0.014104	0.003288	-4.289579	0.0000
Company size	-0.115737	0.033199	-3.486106	0.0005
Return on equity	-0.230608	0.151048	-1.526725	0.1270
Return on investment	0.418019	0.279615	1.494978	0.1350
Company age	0.008483	0.004446	1.907996	0.0565
The coefficient of determination is 0.295923.		Adjusted coefficient of determination 0.29032		
Durbin-Watson Statistics 1.669796		The F-statistic is 33.18283.	probability of the F-statistic: 0.000000	

7. Conclusion

The main aim of the present study is to answer the question, "What is the relationship between unconditional conservatism and the cost of capital by emphasizing the corporate social responsibility disclosure? For achieving this purpose, hypotheses have been developed according to the criteria of theoretical foundations and the research background. Hypotheses have been tested for 5 years from 2018-2022. Data are also calculated on an annual basis. The variables of this study were calculated using Excel software, and then the IEEE 7 software was used for analysis of the data. The model estimation is also a panel type, and multivariate regression is used.

The results of the first hypothesis test showed that there is no meaningful relationship between unconditional capitalism and capital cost, which means that unconditional conservatism does not affect the cost of capital of companies.

According to the results of the second hypothesis testing, there is no significant negative relationship between the unconditional conservatism and the cost of capital.

Unconstrained conservatism does not affect the cost of corporate capital. According to the results of the second hypothesis testing, there is a negative and significant relationship between the social responsibility disclosure and the corporate cost of capital.

In other words, if corporate social responsibility disclosure increases, the corporate cost of capital reduces, and a unit of change (increase or decrease) in corporate social responsibility disclosure leads to an inverse change of 0.15 unit in the cost of capital, which is consistent with the findings of Larosa et al. (2017) and Lee and Liu (2017), which show that there is a negative relationship between the quality of corporate social responsibility disclosure and the cost of capital. And this negative correlation is even more obvious among environmentally sensitive industries. And it's of utmost importance for state-owned companies. Finally, according to the results empirically, there is a negative relationship between the disclosure level of corporate social responsibility and the cost of stock capital among large companies, which is greater than for smaller ones.

Finally, according to the results of the third hypothesis testing, there is a positive and significant relationship between unconditional conservatism and corporate social responsibility. In other words, if unconstrained conservatism increases by one unit, it leads to a direct change of 0.66 units of the corporate social responsibility disclosure.

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