Economics World, Oct.-Dec. 2021, Vol. 9, No. 4, 178-183
doi: 10.17265/2328-7144/2021.04.005

Interest and Social Responsibility

Živko Bergant
College for Accountancy and Finance, Ljubljana, Slovenia

The author shows some fundamental shortcomings and weaknesses of modern corporate finance theory and banking practice about interest and its role in the business and in the life of the people as well. It is especially important in terms of social responsibility. Huge changes are needed. Some of them are discussed in this paper.

Keywords: interest, social responsibility, stakeholder, value-added law

Introduction

Thinking about interest from social responsibility point of view, usually considers two starting points that are very understandable on the first sight. First is the fact that interest is normal obligation in business contracts and must be payed accordingly. Second, interest is a deductible item from the company's tax base, resulting in "tax shield" and financial leverage.

In following, both starting points will be discussed in terms of social responsibility. To do so, some notions should be defined more carefully. These are mainly: the purpose of the company, the value added, and the stakeholder.

The Purpose of the Company

Half of century after Milton Friedman (Friedman, 1970) argued that the only responsibility of business is to make money for shareholders, the corporate purpose remains still a controversial topics (Edmans & Gosling, 2020). Obviously, there are two sides. On one side, there are the authors, who argue that profit is not the only purpose and that organizations should make a drift from profit maximization to the value maximization, because of considering also the stakeholders' interests (e.g., Freeman et al., 2010, p. 24). On the other side, there are the authors, who still stubbornly defend shareholder value as a main purpose of organizations, especially on long-term (e.g., Edmans & Gosling, 2020). Hence, the dilemma still remains vital and unsolved. Such a situation diminishes the value of stakeholder theory (Bergant, 2020a) and all efforts regarding the development of corporate social responsibility remain almost near to philanthropic principles (Bergant, 2020b). Different proposals to overcome the dilemma can be found in the literature.[1] In following, the purpose of the company will be defined on the basis of value-added law, which includes two aspects:

1. Value added is the net outcome of the organizational system in managing the risk inherent to the system and belonging to risk holders in proportion to their contribution to the functioning of the organizational system (the aspect of creating value added).

Živko Bergant, Ph.D., assist. professor, College for Accountancy and Finance, Ljubljana, Slovenia.
Correspondence concerning this article should be addressed to College for Accountancy and Finance, Ljubljana, Slovenia.

[1] More about it in Bergant (2021a).

2. The disproportionately high or disproportionately low participation of individual risk carriers in the value added (according to their work contribution) increases the entropy of the organizational system and threatens the realization of its sustainable development (the aspect of value-added guidance and its distribution).

The value-added law is general because of its validation in all socio-economic systems (past, present, and future), which are oriented towards sustainable development. The value-added law operates regardless of the wishes or activities of the participants and regardless of the normative organization of the organizational system or its environment. It is, therefore, completely independent of the human will that created the organizational system. The value-added law has various forms of its presence in different economic and political environments and in different types of organization (relations between people) of associations.

On the basis of the value-added law, the entropy of organizational systems is mainly the result of the imbalance between participants' contributions and their participation in value added. This imbalance is devastating because it works against cooperation and mutual trust, which is necessary in the context of interdependence (Judt, 2011, pp. 57, 80).

The contribution to the functioning of the organizational system also should be understood in its broadest sense, i.e., in all possible forms (e.g., materialized work, such as real and monetary inputs, knowledge, and of course current physical and intellectual work, including guarantees and opportunity costs or losses of individual participants).

From above, it is clear that following profit instead of value added is not the right way. Profit cannot be a basis for sound sustainable policy. The main purpose of the company from social responsibility point of view is therefore the value added that will be defined more profound in next section.

The Value Added

The value added is the value that does not diminish social welfare although it is completely spent (Bergant, 2021b, p. 60). Therefore the creation of value added means higher social well-being level.

The value-added law includes the equality as a fundamental ethical category, which is not only the result of some subjective thinking about ethics or moral norms (e.g., honesty). The ethics is an objectively inseparable component of the value-added law due to the interdependence of people in a society as a system. Therefore, there is no need any more to stress ethical principles as a reason for corporate social responsibility.

There are also some economic characteristics of the value added:

1. It is created because the basic human need for existence and the sense of being threatened instigate the interests that underline human action.

2. It offers the answer, to why the work is transformed into value added. It is about managing risk to ensure adequate safeness.

3. It offers the justification as the most important long-term goal of the organizational systems in purpose to ensure the sustainable development and existence of organization and of humanity as a whole.

Stakeholders

A relatively large diversity of stakeholder definitions in professional literature is obvious; therefore it is useful to structure or classify them appropriately. Relatively broadly, stakeholders may include: shareholders, government with its agencies, stock exchanges, creditors, banks and financial institutions, financial investors and analysts, internal management, employees, unions, customers, suppliers, general public, potential investors (Idowu & Louche, 2011, p. 1247). Some authors add: media, competitors, consumer protection organizations, communities and other special interest groups (e.g., Freeman et al., 2010), or various forms of civil society (e.g., Matten in: Henningfeld, Pohl, & Tolhurst, 2006). Brooks and Dunn (2018, p. 17) and Byars and Stanberry (2018) define stakeholders similarly broadly. Some authors go even further in stakeholder definitions, including even terrorists, extortionists, and thieves (Freeman in: Jensen, 2002). In addition, the classification of stakeholders is important in terms of the content of reporting required by the IESBA Code in Point 220 (IESBA, 2018) as well.

The main stakeholders' characteristics are that they bear some risk, connected with the corporation business. This fact offers a new (better) definition of stakeholders, namely: Stakeholders are those who contribute to risk management in the company's operations in creating value added. This contribution means that the stakeholder assumes a certain part of the risk in the company's operations. At the same time, this fact also provides a substantive basis for justifying the company's liability to the stakeholders from corporate social responsibility (CSR) point of view.

From the point of view of risk-taking, stakeholders can be divided into:

1. Non-governors, i.e., those, who bear a small part of the company's risk and whose common feature is that they are directly or indirectly affected by better or worse results from the company's operations, but cannot directly influence business decisions; however, they have the possibility of different types of control:

- Financiers or creditors to whom interest belongs;
- Employees as non-co-owners and their union;
- Supervisory authorities within the corporation;
- The state, to which the taxes belong;
- Minority shareholders and portfolio investors to whom dividends or other forms of participation in the value added belong (inactive co-owners of the company's capital);
- The narrower and also wider society in various organizational forms that may be affected by the association, for example through its environmental policy.

2. Governors and management who, in addition to bearing the risk, also contribute to risk management through their decisions; these are mainly employees who are co-owners and partners or majority shareholders (active co-owners of the company's capital) and top management (management), but they can also be others (e.g., business partners who contractually assume part of the risks by participating in the joint venture or in the case of strategic outsourcing).

It should be emphasized that these groups are not static, but change, as their interest, and thus the obligation of the association, can change relatively quickly for a variety of reasons. This means that group members (individuals or associations) move from one group to another. Stakeholders' interest varies depending on how strongly they feel the risk they are exposed to. This feeling is more and more present with the development of civilization, especially informatics and media. It also increases the interest in greater influence in the corporate operations. The above definition of stakeholders is mainly principled, as they also differ according to which corporation (and its specifics) we have in mind. The final definition of stakeholders is therefore objectively conditioned by the concretely selected entity. It logically follows from the word stakeholder that stakeholders should also participate (in the proportion to the risk taken) in the value added created. However, this logic is not fully implemented. The society (including the state) should recognize this interest by formally enabling stakeholders to have an appropriate influence on the operations of a particular corporation (at least in supervising the operations), and thus on managing the risk they take.

Banks as Stakeholders

Banks, one way or another, sooner or later, bear part of the business risk of their debtors. This is evidenced by urgent provisions in banks, requests for additional collaterals, and in particular by write-offs of receivables (agreed or in compulsory settlement proceedings or in the event of the debtor’s bankruptcy). Especially when writing off debts, the dominance of business logic is shown. This means that business life does not follow the contractual obligation rule. The better position of banks is entirely due to the contractual relationship, which is purely administrative in nature and has no basis in business or economic logic. There is no study that would economically justify the feasibility of such an arrangement. Most authors, especially in English and American professional literature, do not usually deal with this, but take such an arrangement as a given fact.

It can be understood by business logic the right of stakeholders to take part of the business risk. The contradiction with the contractual payment of interest is reflected in the write-off of bank receivables when business logic prevails (banks’ credit risk). Namely, it shows that the content of bank’s credit is not a contractual relationship, but a business partnership, where the risk should be distributed among the stakeholders. However, in many countries, the interest payments are independent of debtor’s business performance. Such legislation is a fundamental source of the trap of borrowing, as debt becomes a systemic risk over time and one of the root causes of crises. At the same time, without economic justification it favors the lender in comparison with other stakeholders in the participation in the value added. Considering the value-added law, such rules mean an embedded instrument of instability (Bergant, 2021b, p. 70). At the same time, the obligatory payment of the interest means also a built-in instrument of inequality considering other stakeholders.

Therefore, the interest that belongs to bank is by it content an integral part of value added, created by a debtor. Interest is therefore a form of bank’s participation in the distribution of the value added. Such a relationship by its content does not require obligatory payment of interest, because it should depend on the volume of value added, created. In this way, the bank would also formally assume part of the risk in the debtor’s operations.

The above statements mean the justification for treating banks in the stakeholder group, non-governors, especially due to the fact that banks in their own way control business borrowers and thus partly also impact on business decisions.

There are two ways to improve the above problems.

Firstly, it is possible to implement the system of project financing that is nowadays practiced in minor volume. It is possible without changing the legal system. The possible change of debtors into partners, of course, requires participation in management, for which most banks today are not qualified. Such a change seems idealistic today, but the very model of added value is also idealistic (for now). Regardless, banks could show more understanding of their social responsibility in this way.

Secondly, it is possible to change the obligation law. Unfortunately it requires much more effort from numerous factors involved. A very good example, how to do this, offers Sharia law. In Islam banking, there is no talk about interest. Contrary, the interest is prohibited (Amjid, Ali, 2010, p. 3).

Financial Leverage From Social Responsibility Point of View

In the model, operating leverage is the assumption of unchanged interest costs when changing the volume of revenues. This is not entirely realistic, since a larger volume of business requires also greater funding volume.

This fact has two implications for the traditional model of financial leverage:

1. The financial debt is generally cheaper than equity, because it does not carry the same risk (equity is more expensive for a risk premium).

2. Interest is a deductible item from the tax base, resulting in an additional reduction in the debt price, due to the "tax shield".

In the value-added model, the assumptions of financial leverage are changed (Bergant, 2021b, p. 104):

1. Investors normally expect higher return comparing to creditors but only a part of this return presents fixed costs of financing, in line with the contract. This assumption should be considered in the model of operating leverage, where the opportunity costs of capital increased fixed costs as shown. The other part of the expected return on capital is incorporated in the value added and therefore depends on its volume. It means that this part of return is really riskier and depends also on company's distribution policy regarding surplus value added.

2. The deductibility of the interest from the tax base has a total arbitrary character, because it is regulated by the tax legislation. This is just an expression of the tendency to reduce the credit risk of banks. The better position of creditors is entirely due to the contractual relationship, which is purely administrative in nature and has no basis in business or economic logic. There is no study that would economically justify such an arrangement. Most authors, especially in western professional literature, do not usually deal with this, but take such an arrangement as a given fact despite it means an important and unnecessary motive for higher indebtedness of organizations.

On the above discussion, consistent with this idealistic view, there is no need to address financial leverage in the value-added model, because it simply does not exist anymore. It could be discussed only in a transitional period until the changes in tax legislation, but it will not be dealt in this paper.

Conclusion

Changes in the understanding and regulation of the interest system are undoubtedly one of the most difficult challenges, but they obviously require the consistent exercise of social responsibility in this area as well. It is important to note, however, that change is needed. Without this, nothing will happen, and the current situation is far from satisfactory.

References

Amjid, A., & Ali. (2010). *Islamic Finance. Instruments and markets.* London: Bloomsbury Information Ltd.

Bergant, Ž. (2020a). Basic problem of the stakeholder theory from a corporates' social responsibility point of view. *International Journal of Business Marketing and Management, 5*(11), 117-119.

Bergant, Ž. (2020b). Debates on corporate social responsibility are becoming similar to the philanthropy. *International Journal of Advances in Management and Economics.* Retrieved from http://www.managementjournal.info/index.php/IJAME/issue/view/72

Bergant, Ž. (10th June 2021a). The problem of organization's purpose as a basis for its socially responsible behavior. *16th IRDO International Scientific Conference Social Responsibility and Current Challenges 2021: Challenges and Opportunities of Digitalisation for Sustainable Future*. Retrieved from https://www.irdo.si/irdo2021ref/referati/01-b01-zivko.pdf

Bergant, Ž. (2021b). *Accountancy and social responsibility. An innovative new approach to accountancy theory and practice.* Cham, Switzerland: Palgrave Macmillan.

Brooks, J. L., & Dunn, P. (2018). *Business and professional ethics for directors, executives & accountants.* Boston: Cengage Learning.

Byars, M. S., & Stanberry, K. (2018). *Business ethics*. Houston: OpenStaks.

Edmans, A., & Gosling, T. (2020). How to give shareholders a say in corporated social responsibility. *The Wall Street Journal.* Retrieved from https://www.wsj.com/articles/how-to-give-shareholders-a-say-in-corporate-social-responsibility-11607270401?st=qm9ilrlogjb8o0f&reflink=article_gmail_share (accessed on May, 2021)

Freeman, R. E., Harrison, J. S., Wicks, A. C., Parmar, B. L., & Colle, S. (2010). *Stakeholder theory (the state of the art).* Cambridge: Cambridge University Press.

Friedman, M. (September 13, 1970). The social responsibility of business is to increase its profits. *New York Times*, p. 33.

Henningfeld, J., Pohl, M., & Tolhurst, N. (2006). *The ICCA handbook on corporate social responsibility.* Chicester: John Wiley & Sons Ltd.

Idowu, O. S., & Louche, C. (2011). *Theory and practice of corporate social responsibility*. Berlin: Springer-Verlag.

International Ethics Standards Board for Accountants (IESBA). (2018). *Handbook of the international code of ethics for professional accountants.* Retrieved from https://www.ifac.org/system/files/publications/files/IESBA-Handbook-Code-of-Ethics-2018.pdf (accessed on November, 2020)

Jensen, C. M. (2002). Value maximization, stakeholder theory, and the corporate objective function. *Business Ethic Quarterly, 12*(2), 235-256.

Judt, T. (2011). *Deželi se slabo godi* (The country is in a bad shape). (In Slovene). Ljubljana: Mladinska knjiga založba d.d.