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Linking corporate social responsibility to firm default risk

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Summary Corporate social responsibility (CSR) is receiving a growing attention from both academic researchers and business managers. Prior research suggests that CSR, by its ability of building strong corporate image and reputation, effectively improves a firm's performance. However, few studies have explored the relationship between CSR and firm risk factors. In particular, although the ongoing financial crisis spurs scholars to seek new drivers that help a firm regain its well being, an important financial indicator of a firm, default risk, has been largely neglected. This research bridges this gap and empirically examines the relationship through which CSR helps firms reduce the risk of falling into default. In addition, this paper formulates the moderating effects between CSR and firm capability, environmental dynamism/complexity, and describes a more complete pattern of CSR's function under different internal and external conditions. The results confirm that CSR has a strong effect on default risk reduction, and this relationship is stronger on firms in high dynamism environments than in low dynamism environments.

1. Introduction

Corporate social responsibility (CSR) receives growing consideration as modern companies recognize that CSR is an effective instrument connecting them to various stakeholders. Statistics show that ninety percent of Fortune 500 companies openly announce efforts towards socially responsible activities (Kotler & Lee, 2004; Lichtenstein, Drumwright, & Braig, 2004). For example, Altria spent more than $1 billion on social projects such as preventing domestic abuse, feeding the ill and the elderly, and responding to disasters like Hurricane Katrina. Along with business managers, academic researchers have been attentive to this trend and pursued in-depth studies involving the impacts of CSR on firm performance such as customer donation behaviors (Lichtenstein et al., 2004), customer satisfaction and firm market value (Luo & Bhattacharya, 2006), firm idiosyncratic risk (Luo & Bhattacharya, 2009), consumer buying behaviors (Sen & Bhattacharya, 2001), consumer response to products (Brown & Dacin, 1997) and consumer attitudes to products (Berens, van Riel, & van Bruggen, 2005). These studies demonstrate that CSR contributes positively to various aspects of a firm's success.

However, given the mounting recognition of the importance of CSR, it is surprising to notice certain areas remain underexplored. Although CSR is confirmed to positively

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influence firm performance such as customer metrics and shareholder value, there is little existing knowledge about how CSR impacts firms' default vulnerability. This type of risk, when many firms have failed to pay their debt during the past few years, becomes a critical yardstick by which a firm's financial health can be reliably evaluated. Meanwhile, the bond market is the single largest external financial source and default risk reflects the likelihood a firm gets support from this massive source (Anderson & Mansi, 2008). Thus, the importance of firm default risk, combined with the growing emphasis on CSR, yields a worthy research avenue: Does CSR also exert a significant and beneficial impact on reducing default risk, as it does on other performance indicators?

Understanding CSR's effect on default risk reduction may be of significant importance both for advancing theories regarding the social aspect of corporate strategy and for providing practical implications for firm management. First, CSR represents a special type of firm expenditure that deviates from targeting the firm's immediate customers. This society-focused effort may appeal to a broader range of stakeholders than other firm expenditures do, and therefore it could generate a multi-faceted protection mechanism that shields the firm from risks. Extending this protection to default risk further illustrates CSR's unique and thus far unrevealed roles. Second, CSR has a distinctive ''attribution'' characteristic that other strategic investments do not. Through CSR, stakeholders such as consumers identify themselves and likely build stronger relationships with the firm. Linking this unique function to baseline outcomes such as default risk justifies the feasibility of employing CSR activities in a strategic manner and encourages managers to consider CSR options along with other firm expenditures. Third, extant research emphasizes examining CSR's impact on a firm's immediate performance such as consumer metric benefits. Those benefits, although important, cannot reflect the fundamental health of the firm. For example, CSR increases financial benefits but at the same time consumes a significant amount of financial and human capital. Default risk represents an essential indicator of a combination of gains and costs of firm investment. Thus, linking CSR and default risk is a more reliable way to demonstrate CSR's actual contribution. Fourth, default risk represents a forward-looking performance indicator of a firm. Confirming CSR's link to this type of risk factor further extends the understanding of its long-term nature and helps the firm's planning process.

In addition to the direct link between CSR and default risk, some moderating effects deserve consideration. Firms have different internal endowments and operate under different external conditions. We examine whether the relationship between CSR and default risk differs as those conditions vary. Internally, firm dynamic capability has been defined by resource-based theories (RBT) and dynamic capability theories (DCT) as the firm's inherent competency in managing its internal factors (Teece, Pisano, & Shuen, 1997). A firm with high capability may more successfully utilize CSR activities because of its competence in organically combining CSR activities with other corporate strategies. Evaluating how CSR functions at different levels of firm capability deepens the understanding of CSR benefits. Also, it has been suggested that environmental moderating effects cannot be neglected when studying firms' attributes and their impact on performance (Atuahene-Gima & Murray, 2004; Donaldson, 2002; Lawrence & Lorsch, 1967; Zeithaml, Varadarajan, & Zeithaml, 1988). In order to depict a more useful relationship pattern between CSR and default risk, it is meaningful to incorporate external factors that may affect CSR's strength on default risk.

To this end, this paper examines the effect of CSR on default risk reduction. It also examines whether the strength of the relationship between CSR and default risk varies when firms differ in their capability and when environmental dynamism and complexity vary. This paper attempts to contribute to CSR literature and firm risk management literature. This paper also attempts to generate important implications for business managers who are struggling to improve their financial situations and gain healthier debt conditions.

This paper is organized as follows. In the second section, theoretical foundations are discussed and the hypotheses are developed. The third section presents the data collection process, measurements, and analytical methodologies. In the fourth section, the hypotheses testing results are presented. A discussion is provided in the fifth section, followed by the limitations and future research directions.

2. Theoretical foundations and hypotheses

2.1. Default risk

Default risk refers to the likelihood that a firm with debt will lack the ability to repay the principal and interest for its debt obligations as stipulated (Bakshi, Madan, & Zhang, 2006; Vassalou & Xing, 2004). In the finance, management, and marketing literature, default risk is viewed as an important indicator of firm health (Foster, Ward, & Woodroof, 1998; Moulton, Thomas, & Pruett, 1996; Rego, Billett, & Morgan, 2009). Compared to the abundant research on stock return and risk in the literature, firm default risk has received less attention. However, researchers agree that default risk deserves further exploration because debt holders have significant impact and hold special interests in the firm (Anderson & Mansi, 2008). While firm shareholders are residual claimants, debt holders earn a fixed claim on the firm. This means that the debt holder will be particularly cautious about a firm's likelihood to fall into temporary and long-term financial distress (Anderson & Mansi, 2008). Default risk is directly bonded to debt holder welfare, and thus it is one of the issues that most concerns them.

Debt holders are not the only stakeholders that assess firm default risk. Research also shows that high default risk is associated with low stock return (Campbell, Hilscher, & Szilagyi, 2008; Dichev, 1998). Firm valuation and assessment of liquidity usually involve debtor risk evaluation (Brealey, Myers, & Allen, 2008). Therefore, default risk should be one of the main concerns of shareholders along with debt holders. Internally, managers will be particularly interested in reducing default risk because it is likely to cause higher cost of capital and operations difficulties. Also, the bond market is the single largest source from which firms can seek external financing, so managers are motivated to reduce their default risk in order to ensure sufficient future support from this source (Anderson & Mansi, 2008).