Interview: Saurabh Mishra

Law firms that invest in corporate social responsibility can reduce their financial risk, Saurabh Mishra tells Manju Manglani

There is a direct and measurable link between corporate social responsibility (CSR) initiatives and financial performance, according to Saurabh Mishra and Sachin Modi.

Their research found that an increase in a firm's positive CSR will lead to a 20 per cent reduction in financial risk. By contrast, an increase in negative CSR will result in an 11 per cent increase in financial risk.[1]

Mishra, a professor at Desautels Faculty of Management, McGill University in Canada, outlines the implications of these findings for law firm leaders.

Why is the link between CSR and financial risk in firms relevant in 2014?

While the global economy is beginning to recover from the great recession, there remains significant uncertainty regarding its future trajectory. This uncertainty has implications for the volatility of the financial markets and translates into greater financial risk for firms.

Even though a part of firm's financial risk is determined by market- and economy-wide factors that remain beyond the direct control of managing partners, a considerable portion of financial risk is 'idiosyncratic' to firms. This idiosyncratic component of financial risk can be managed and lowered through proactive planning and strategic initiatives.

Our research shows that CSR initiatives provide one such mechanism through which firms can manage and lower the idiosyncratic portion of their financial risk. As such, CSR protects firms against the financial volatility in the current economic environment to a considerable extent.

Why should law firms with corporate clients have a greater focus on CSR?

Law firms with corporate clients should have a greater focus on CSR for at least two reasons. First, as we mention in our paper, current research shows that CSR provides a number of intangible benefits such as brand equity for firms and the generation of positive associations among clients.

This would imply that law firms with a focus on CSR would enjoy higher equity with existing and potential corporate clients, and thus derive greater benefits than firms not engaging in CSR. Indeed, higher equity should translate to greater client satisfaction and lower acquisition and retention costs for CSR-focused law firms.

> **"Firms that are financially over-leveraged should avoid investing in CSR"**

Second, and perhaps more importantly, CSR is also known to generate 'moral capital' for firms in society. Such moral capital becomes even more important for law firms that represent clients in courts. A law firm that is 'tainted' may find itself in a weaker position when representing clients than a firm that has a reputation for being socially responsible.

What impact can CSR have on a law firm's financial performance?

Generalising our findings, publicly-traded law firms that focus on CSR can expect to see lower idiosyncratic risk in the stock markets. Idiosyncratic risk forms an important component of the total volatility in the stock price of a firm, and a reduction in it can both instil greater confidence among investors as well as lower the cost of capital for firms.

For private law firms as well, the mechanisms driving the results of our study (such as higher brand equity and greater employee satisfaction) would indicate that a focus on CSR would lower the variability of their future expected cashflows.

As such, positive CSR would smooth the future financial performance of privately-held law firms and give greater confidence to their owners. On the flip side, negative CSR would elevate fluctuations in their future financial performance and thus detract them from realising their strategic goals and objectives.

How can positive and negative CSR affect stakeholder value?

Key stakeholders of firms include clients, partners, staff, network firms and investors. A significant body of research (as cited in our paper) shows that positive CSR

TOP TIPS TO REDUCE YOUR FIRM'S FINANCIAL RISK THROUGH CSR

1 Focus on increasing both positive and reducing negative corporate social responsibility (CSR). If you are doing a lot of positive CSR but at the same time are engaging in socially irresponsible actions, the two can cancel each other out.

2 CSR is complex and multifaceted, and should not be limited to community-based or environmental initiatives. Responsible management of all key stakeholders' expectations is critical for maximum financial risk benefits from CSR.

3 Focus on CSR only if you have the financial wherewithal to support it. Taking on debt to 'do good' is not going to produce favourable financial results.

enables firms to manage the expectations of these stakeholder groups. In particular, positive CSR has been shown to generate positive attitudes and beliefs for firms among stakeholders.

For instance, consumers are more likely to trust firms that are behaving in socially responsible ways and to identify with such firms by buying their products and services. On the other hand, socially irresponsible initiatives are likely to generate consumer resentment and even boycotts of firms.

Similarly, employees are often more satisfied with their jobs if they feel that their employers are behaving in a socially responsible manner. Network firms are also more likely to trust firms that engage in positive CSR, believing that such firms would do the 'right' thing and behave opportunistically towards them.

Finally, given that all other stakeholders are likely to be positively influenced by positive CSR, the expected effect of these on firm performance would generate higher value for investors and law firm partners.

Negative CSR does the opposite in all of these cases.

What role does a firm's financial leverage play in how CSR affects its financial performance?

Our research findings show that firms with high financial leverage derive lower financial performance benefits from CSR. In particular, our results indicate that firms should invest in positive CSR only if their debt levels are low and if they are in a financial position to support their social commitments over time.

Highly leveraged firms face significant funding challenges and so are unable to provide credible signals regarding their future commitment towards CSR. This can adversely affect shareholder perceptions and thus lower the benefits that firms gain from CSR. So, firms that are financially over-leveraged should avoid investing in CSR.

What are the pitfalls that firms should avoid when creating a CSR programme?

As stated earlier, CSR is multifaceted and many factors together determine the overall social impression of firms.

For instance, community-based activities such as charitable giving, support for education, and volunteering for social programmes are not the only things that comprise CSR. Focusing on corporate governance, promoting diversity within the organisation, taking care of employee needs and paying attention to environmental issues are equally important. Firms often emphasise one or two aspects, while overlooking others. This can be detrimental to their financial performance. As such, a holistic perspective is a must when creating a CSR programme.

If I were to advise someone on how to avoid financial loss, I would say that negative CSR matters too. Before you become operational in a new environment – be it national or international – you have to understand its culture inside out.

This means managing your practice according to that environment and making sure that you follow local societal protocols, or it might ultimately cost you financially. Do not ignore any social and cultural norms of the market in which you operate. mp

Manju Manglani is editor of Managing Partner *(www.managingpartner.com)*

Endnote

1. See 'Positive and Negative Corporate Social Responsibility, Financial Leverage, and Idiosyncratic Risk', Saurabh Mishra and Sachin B. Modi, *Journal of Business Ethics*, 2013 (117:431–448)