Corporate Social Responsibility and Long-term Compensation: Evidence from Canada

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ABSTRACT. This paper examines the association between long-term compensation and corporate social responsibility (CSR) for 90 publicly traded Canadian firms. Social responsibility is considered to include concerns for social factors and the environment (e.g. Johnson, R. and D. Greening: 1999, Academy of Management Journal 42(5), 564–578; Kane, E. J.: 2002, Journal of Banking and Finance 26, 1919–1933; McGuire, J. et al.: 2003, Journal of Business Ethics 45(4), 341–359). Long-term compensation attempts to focus executives’ efforts on optimizing the longer term, which should direct their attention to factors traditionally associated with socially responsible executives (Mahapatra, S.: 1984, Journal of Financial Economics 20, 347–376). As hypothesized, we found a significant relationship between the long-term compensation and total CSR weakness as well as the product/environmental weakness dimension of CSR. In addition, we found a marginally significant relationship between long-term compensation and total corporate responsibility. Our findings are that executives’ long-term compensation is associated with a firm’s environmental actions, and that firms that utilize long-term compensation are more likely to mitigate product/environment weaknesses than those that do not. Implications for practice and research are discussed.

KEY WORDS: corporate governance, executive compensation, social performance, social responsibility

The impact of modern economic activities on the quality of human and social life has led to a growing concern in society about corporate social responsibility (CSR). This concern is reflected in wider press coverage, academic and practitioner research, business textbooks and in curricula of business schools. Recently, the topic of CSR resurfaced in a number of important business and political arenas. During the past two years, governments (United Nations in Canada, 2002), corporations (Delfgaauw, 2000), professional accounting associations (Canadian Institute of Chartered Accountants (CICA), 2001), and professional services firms (Deloitte Touche Tohmatsu, 2002) appear to be recognizing a significant expansion and degree of permanence in society’s demand for CSR.

The nature of a firm’s corporate governance is used to persuade executives to emphasize particular firm goals and objectives (Zeckhauser and Pound, 1990). An important component of corporate governance is the executive compensation structure, which is used to reward executives for working toward particular goals and outcomes (Amihud and Lev, 1981; Holmstrom, 1979; Jensen and Meckling, 1976). Theoretically, fixed and shorter term incentive structures are assumed to motivate executives’ consideration for immediate term performance that is often based upon retrospective accounting numbers. In contrast, longer term compensation based upon market valuation...
tends to motivate executives’ consideration for CSR (Kane, 2002).

On the one hand, because immediate compensation is based on accounting measures that are retrospective indicators of performance, executives compensated solely based on salary and short-term bonuses are not focused on factors that influence CSR. On the other hand, market value incorporates a broader range of indicators of performance. If CSR increases the market value of a firm in the longer term, then the use of executive compensation contingent on market value will encourage executives to focus on factors that are consistent with CSR. Thus, executive compensation that is contingent on market valuation is consistent with a concern for CSR as executives must consider potential costs and benefits of environmental and social factors that may impact firm performance in the long term (Mahapatra, 1984). Consequently, executive compensation that is contingent on market performance can be a potentially important corporate governance mechanism through which board of directors can direct executives to focus on specific objectives having social implications (McGuire et al., 2003).

In this paper, we examine the research question of whether longer term contingent executive compensation is associated with increased attention to CSR (Mahapatra, 1984), and more specifically, which types of CSR are associated with long-term contingent executive compensation (e.g. Johnson and Greening, 1999; Kane, 2002; McGuire et al., 2003). To test this research question, we empirically examine the association between long-term compensation and CSR for 90 Canadian firms. We measure CSR by the ratings in the Canadian Social Investment Database (CSID), at an aggregate level and through the decomposition of the index by product/people dimension as well as by Weaknesses and Strengths. We rely on this wide-spread measure of CSR for firms listed on the Toronto Stock Exchange (TSE) 100. As anticipated, we found a significant relationship between the long-term compensation and the product dimension of CSR, as well as a marginally significant relationship between long-term compensation and total corporate responsibility.

This study extends prior research in three ways. First, we specifically extend our understanding of the association between CSR and contingent compensation using refined measurement techniques of longer term compensation. Second, we delve into the components of CSR through the examination of both the total product and the total people dimensions (Johnson and Greening, 1999). Finally, we provide important insights into CSR and corporate governance by investigating the association between executive compensation and CSID for Canadian firms during the period of 1992 through 1999, which provides guidance to firms when designing compensation plans.

Corporate social responsibility and corporate governance

Even though a precise definition has not been agreed upon in the literature, CSR is considered to be comprised of factors that encapsulate a firms’ attention to social and environmental issues (Clarkson, 1995; Hillman and Keim, 2001; Swanson, 1995; Wood, 1991). According to Wartick and Cochran (1985), corporate social responsibility incorporates the interaction between the principles of social responsibility, the process of social responsiveness, and the policies and programs designed by corporations to address social issues. As Carroll (1979) summarizes, CSR encompasses a firm’s consideration of its responsibility to investors and consumers, ethical responsibilities to society, legal responsibility to the government or the law, and discretionary responsibility to the community.

Our paper is built on the premise that actions taken or decisions made by firms that maximize longer term firm performance tend to be socially responsible (c.f., Mahapatra, 1984). We implicitly adopt an agency perspective that suggests that executives make decisions that are consistent with their self-interest (e.g. Baiman, 1982). The concept of opportunism was developed by economists to operationalize the task of validating executives’ violation of social norms. An “agent” is said to be a perfect opportunist if their choice of actions is based exclusively on self-interest and is not influenced by a desire to respect social norms (Magill and Quinzii, 1996). Accordingly, a perfectly opportunistic executive is one who would honor the public’s interests only when it is in their self-interest to do so. Often cited are the recent examples of Enron and WorldCom where executives’ actions were guided