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Corporate social responsibility and CEO compensation revisited: Do disaggregation, market stress, gender matter?

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ABSTRACT

In this paper we examine the relation between corporate social responsibility (CSR) and CEO compensation. Both CSR and CEO compensation are disaggregated into various sub-components. We also consider impact of the market crisis and the relevance of gender. Our results show that there is a negative relation between total compensation and socially responsible firms. However, disaggregation of CSR into its components matters. Dimensions of CSR that are relevant are employee relations, environment and diversity. Our results also show that the financial crisis and gender matter: once they are accounted for interactively in the model, the general relation between CSR and compensation weakens.

1. Introduction

In this paper we examine the linkage between corporate social responsibility (CSR) and CEO compensation. CSR is measured using the rating system from Kinder, Lindenberg, and Domini (KLD) Research and Analytics database where firms are rated based on the strengths or weaknesses of a corporation with respect to their environmental activities, community involvement, product qualities, employee relations and diversity policies.[1] CEO compensation is divided into various components:

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[1] KLD also provide ratings on corporate governance and human rights. These are excluded from our analysis because CEO compensation is intrinsic in governance. Human rights is very specific to certain events in areas such as Burma and South Africa or indigenous relations and hence has a very low sample variation. These exclusions are consistent with Cai et al. (2011).

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Salary, Bonus Cash and long-term compensation. Although the relation between CSR and CEO compensation has been examined in the prior literature (see for example Cai, Jo, & Pan, 2011), our main contribution lies in the consideration of the impact of the recent financial crisis, the relevance of gender and the division of both CEO compensation and the CSR measure into subcomponents. Such a decomposition of the key variables allows a more in-depth analysis of the identified relations.

To hypothesize that there is a relation between CSR and CEO compensation requires an assumption that the reward to a CEO is not just monetary in nature but that there are also intrinsic rewards. Thus, what motivates a CEO and is the reward the same for all CEOs? Intuitively we would expect a range of CEO leadership styles, motives, compensation packages, incentive and personalities. Indeed Chang, Dasgupta, and Gan (2011) suggest that the managerial market is segmented in terms of talent and characteristics. There exists a fit between managers and firms that influences firm outcomes. Research on CEO compensation is traditionally examined in the context of agency theory (Jensen & Meckling, 1976) where the incentives of the CEO are aligned with those of the shareholder. This is an economic theory of explaining compensation (Tosi & Greckhamer, 2004). More recently Van Essen, Otten, and Carberry (2012) argue that managerial power theory (MPT) provides a deeper understanding of the determinants of CEO compensation. MPT allows a focus on board, governance and ownership structures as determinants of compensation. Devers, Cannella, Reilly, and Yoder (2007) provide a cross-disciplinary review of the CEO compensation literature and classifies the majority of studies as addressing the relation between pay and performance and pay and behavior. These relations are potentially endogenous. Tosi and Greckhamer (2004) examine how cultural values are related to CEO compensation. There is a focus on determinants of CEO compensation with an underlying assumption that CEOs seek to maximize their income. However, there is little focus in the literature on the utility function of CEOs and a lack of consideration that reward may be both extrinsic and intrinsic.

Extrinsic rewards are gained from an increase in wealth or consumption. Intrinsic rewards are independent of financial benefits and relate to the utility gained from 'doing the right thing'. CEOs do engage in socially responsible activities at the corporate level. There is a growing awareness of the impact of companies on the community, the environment and a range of stakeholders including consumers and employees. Firms are increasingly disclosing CSR information in response to attention on social and environmental issues among consumers, media, and investors. Firms engaging in CSR take into account the interest of all stakeholders; customers, employees, investors, vendors, the government and the society at large, in contrast to the traditional unitary focus on shareholders. Godfrey, Merrill, and Hansen (2009) argue that CSR is a risk management technique. A socially responsible firm creates goodwill and moral capital. Hence, it is like an insurance policy in the event of unforeseen negative events. Similarly, Godfrey (2005) argues that there is an optimum level of corporate philanthropy which creates a moral capital that ultimately benefits shareholder wealth. The argument in these papers is 'good deeds earn chits'. However, again any intrinsic utility that is earned by the CEO is ignored.

Graafland, Kaptein, and Mazereeuw-van der Duijn Schouten (2010) propose a utility model for executives. They argue that, consistent with Godfrey, there is an optimal level of CSR activity if the CEO is strategically motivated. From this perspective the CEO seeks to increase CSR activity while it results in financial benefits to the shareholder. It is assumed that this increase in shareholder wealth is consistent with an increase in CEO income and, hence, consumption. These CEOs are extrinsically motivated and engage in CSR to raise consumption. However, more altruistic CEOs will derive an intrinsic value from engaging in CSR activity. Hence, they will be prepared to trade off some of their income if they can increase the CSR activity of the firm.

In this paper, we expect that more intrinsically motivated CEOs will engage in more CSR activity. Such CEOs will be prepared to trade-off some of their income for the satisfaction derived from leading a company that behaves in a socially responsible manner. Accordingly, to the extent that this characterizes well the motives of managers, we hypothesize that higher levels of CSR activity will have a negative relation with CEO compensation. Assuming that all CEOs have, other things equal, a highly rewarding salary package, we expect many will engage in CSR activities for strategic purposes. A finding of a negative relation between CSR and CEO compensation will support the existence of intrinsic rewards.