An investigation into why firms use corporate social responsibility incentives in executive compensation packages, how corporate governance plays a role and what the effects are

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Executive compensation is a key tool in the corporate governance tool belt. The rise of the use of non-financial metrics in corporate executive compensation packages has been noted since the 1990's but have generally been evaluated in relation to the financial performance of the firm. One recent change is the rise of Corporate Social Responsibility (CSR) incentives in executive pay packages where targets relating to social and environmental objectives are being included. For example, 20% of Royal Dutch Shell's 2016 bonuses were tied to sustainable development goals (Royal Dutch Shell Annual Report, 2016). Findings vary, but recent reports indicate that 43.4% of the S&P 500 link executive compensation to CSR performance (IRRC and Sustainable Investments Institute, 2013).

Initially, it appears that CSR incentives differ from other non-financial metrics in that firms align these metrics to a perceived definition of sustainability, one that includes financial, social and environmental metrics. While some initial research has begun in this area (Maas, 2016; Flammer et al., 2016), much remains to be explored including the questions addressed in my research.

My thesis investigates three key questions in three papers: first, why do organizations adopt CSR incentives? Second, how does corporate governance play a role? Third, what are the effects of CSR incentive adoption including how do different weightings and types of incentives affect both CSR and financial performance? Corporate governance elements are examined in each paper as this underlies the very nature of the design, adoption and effect of CSR incentives. I propose that the efficient contracts desired by the board may be affected by various forms of stakeholder power. Stakeholder power is a concept that incorporates current theories of managerial power with recent findings that stakeholders affect corporate governance processes. Specifically, I propose that management, institutional shareholders and peer competitors may affect the adoption and implementation of CSR incentives. I also explore how the specific traits of such CSR incentives affect CSR performance as well as financial performance. Finally, I examine how directors' knowledge and experience affect the adoption and effectiveness of these incentives.

I apply structural equation modelling to data gathered from S&P 500 firms. The CSR incentive information is hand collected from firm proxy statements and combined with information from various databases to obtain the performance, ownership and board feature information. I also use instrumental variables to estimate the causal relationship between corporate governance, CSR incentives use and features as well as the effects on CSR and financial performance. Preliminary results, for the first paper exploring why firms adopt CSR incentives indicate that adoption is significantly influenced by the size of the firm as well as its industry. While adoption of these incentives is related to better CSR scores, upon closer examination it appears that CSR incentives are not related to tangible, quantitative CSR improvements (this refers to measurable outcomes like greenhouse gas emissions as opposed to softer outcomes like the presence of a diversity policy). CSR scores are known to be affected by the volume of disclosure a firm provides and do not necessarily reflect tangible outcome performance (Cho et al., 2012). Additionally, early results suggest that firms that offer these incentives pay larger bonuses to named executive officers, even after controlling for a firm's size, industry and other factors. Further analysis of these results is currently ongoing. At least initially, it appears that CSR incentives may not affect tangible CSR performance changes but may provide additional disclosure about the CSR activities of the firm. It is also possible that management are affecting the adoption of these incentives, either to reflect their ongoing CSR efforts, or possibly, to obtain higher compensation. In line with recent calls from major institutional shareholders like BlackRock for firms to pay more attention to sustainability issues, I am currently examining whether shareholders with a long-term view, such as pension funds, may be influencing the adoption of CSR incentives.

This research advances the literature in corporate governance in the design and effect of elements of executive compensation plans, as well as the literature on CSR performance and determinants. Mainly, I build upon the previously established causal model that corporate governance leads to CSR performance which in turn leads to financial performance (Jo & Harjoto, 2012) by investigating various corporate governance mechanisms like executive compensation and the board of directors. These studies improve our understanding of how corporate governance plays a role in CSR incentive adoption and how it affects the design of these plans. My work extends research regarding the motivations of management and other stakeholders by investigating previously unexamined motives for the inclusion of CSR incentives, specifically the possibility that management or institutional shareholders are affecting the process. Practically, I aim to provide evidence that informs boards on the use and design of CSR incentives and how corporate governance structures can support these initiatives. I will document the effect of these incentives on both the CSR and financial performance of the firm allowing this information to be better communicated to stakeholders and shareholders alike. Finally, this research is of interest to shareholders as they demonstrate a growing interest in both executive compensation and social & environmental matters, issues of great importance in corporate governance within Canada today. Overall, we all benefit from understanding why CSR incentives are offered, how corporate governance plays a role and what effect these incentives have both from a corporate and societal perspective.

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