

Do Stock Options Influence CSR Activity?

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Abstract

This paper investigates the impact of stock option of board of directors on Corporate Social Responsibility (CSR) activities using 336 of Korean firms in 2013. Stock options are the most typical form of long-term incentive compensation and are contingent on the value of the stock in the future. We develop and analyze hypothesis, based on stakeholder theory. We find a significant relationship between the stock option and CSR activities, after controlling for various firm characteristics. Our findings are that long-term compensation for executives is positively associated with CSR activities and it attempts to focus executives' efforts on optimizing the longer term. It also implies that the structure of executive compensation could be used as an effective tool to encourage management to undertake socially responsible actions, therefore resulting in more socially responsible firms.

Keywords: CSR (Corporate Social Responsibility), Executive Compensation, Stakeholder Theory

1. Introduction

Intensive competition and market uncertainty are two factors which drive companies to seek long-term sustainability, and this makes CSR one of firms' instrumental strategies that is beyond ethical obligation¹. CSR generally refers to serving people, the environment, and communities in ways that exceed what is legally required of firms. Firms conduct CSR activities for various reasons, but the main reason is to enhance their sustainability.

Long-term incentives can have a positive impact on CSR. Prior studies have offered empirical evidence to endorse the view that by issuing long-term incentives, companies can better align executive's goals with the broader goals of stakeholders. For example² investigated the impact of 1-year lagged executive compensation structure on CSR engagement, CSR strength, and CSR concerns for Canadian firms. They found a significant positive relationship between CEO salary and CSR weakness, between CEO bonus and CSR strengths, and between CEO stock options and total CSR as well as CSR strength. In addition, the negative relationship with regard to CSR weaknesses suggests that firms

avoid taking risks that could potentially lead to adverse effects. However, the research conducted so far has some shortcomings. First, some studies indicate that executives do not engage in risk taking behavior. Meanwhile, it has been demonstrated that the primary objective of issuing stock options is to compel executives into taking risks so as to boost the performance of a firm. Furthermore, firms may increasingly hide their unethical conduct through the new excuse that the project may hold adverse social consequences. Short-term and fixed incentive structures that are assumed to motivate executives' consideration for shorter term performance are often based upon retrospective accounting results.

Conversely, long term compensation which is based upon market valuation tends to motivate executives to consider CSR³. In cases where short-term and immediate compensation is offered to executives, they are compensated based on accounting measures which are not focused on factors that influence CSR. In contrast, if CSR enhances the market value of a firm in the long term, the use of executive compensation contingent on market value will encourage executives to focus on factors that are consistent with CSR. Although long-term compensation of executives can be potentially important to the board of

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directors, they must consider costs and benefits of CSR activities that may impact the firm's financial performance in the long term.

In this research, we investigate whether long-term executive incentives such as stock options are associated with increased CSR activities. To examine this, we empirically tested the relationship between stock options and CSR activities of 336 Korean firms. In line with our expectations, we found a significant relationship between the two.

Our research proceeds as follows: the next section presents our hypothesis. The methodology section describes our samples and defines the variables that we used. The fourth section presents the empirical results and the final section offers the conclusion.

2. Theoretical Background and Hypothesis

The following example will clarify my apprehension toward using this research to justify awarding stock options. The use of stock option has increased since the last two decades and there are different views with regard to stock option compensation – for example, use of stock options for compensatory purposes and the effectiveness of using such a method of compensation.

One of the most common reasons for implementing stock options is to retain and attract management. When management hires an executive, it may provide a stock option in order to lure only those executives who are confident of their ability to raise the stock price. When the stock price appreciates, executives would be more inclined toward staying with the firm for long as their compensation will increase along with the rise in stock price. Thus, the action of awarding a stock option to the executives would be justified. When management has a stock option at its disposal, its goal may align with those of the shareholders. The management concentrates its efforts on trying to increase the stock price and maximizing shareholder wealth.

Imagine a scenario where an unethical executive had to choose whether to apply to a CSR firm or non-CSR firm. If both firms are equal in terms of corporate governance, and if both firms award equal levels of stock options, then the managers would have no additional incentives to make ethical decisions and ignore unethical ones. Only

when CSR firms evaluate their CSR performance and notice it falling, will they become aware of the executive's unethical actions. However, by the time this happens, it may be too late as the executive may have already exercised the options and realized the gains.

Based on the stakeholder theory, firms conduct CSR not only to generate profit and abide to bylaws but also to be ethical and socially supportive^{4,5}. By engaging in CSR, firms can explicitly offer stakeholder protections to prevent underperforming managers from building alliances with stakeholders, and thus improve the efficiencies in monitoring firm managers⁶. The shareholder theory posits that executives engage in CSR to resolve the conflict among various stakeholders. The agency theory generally emphasizes shareholder wealth maximization, and suggests that investments in CSR are made to enhance the private benefits of managers⁷.

Goals of owners and managers can be aligned by offering a meaningful ownership stake to the managers in the firm⁸. Managers are more likely to act like owners if they are themselves owners. Stock option is one way of achieving managerial ownership. Therefore, when managers have a motivation to consider long-term performance, they are expected to engage more in CSR to increase their own personal benefit. If management has a stock option at its disposal, it may align the interests of the executives and the shareholders, and consequently the firms that engage in more CSR activities will have lesser conflicts of interest between managers and stakeholders. Socially responsible firms are willing to forgo short-term profits to invest in social and environmental objectives, which benefit the firm and society in the longer run; in other words. They do not offer immediate payoffs but enjoy profitability in the long term³. Thus, we expect a positive association between the granting of stock options and CSR activities. In view of this, we propose the following hypotheses.

Hypotheses the stock options will have positive effect on CSR activities in long-term.

3. Methods

To investigate the effect of stock option as a long term compensation on CSR activities. We use CSR measure from KEJI index. To measure the CSR activities of Korean firms, we relied on the KEJI index (Korea Economic Justice Institute), which evaluates the CSR activities of

Korean listed firms since 1991. The institute evaluates multidimensional corporate social performance and gives scores on seven individual categories of CSR: soundness, fairness, contribution to society, consumer protection, environmental protection, employee satisfaction, and contribution to the economy. The KEJI index is comparable to the KDL index in the US, which has been used in many recent studies to measure the relationship between CSR and financial performance. We use stock option data were collected from the annual report and KisValue (Korean Information Service Value), which provides financial data.

The key independent variable is a stock option dummy. Firms use stock option as a long term compensation are assigned the value of 1, and others are assigned the value of 0. To test our hypothesis on the relationship between stock option and CSR activities, we estimated the following model. The subscripts I and t represent firm and time, respectively.

We also construct several governance measure, ownership (Owner) and Big Holders (Big hold) as control variables, Discretionary Accrual (DA), Return On Asset (ROA), firm size (Size), Leverage (Lev) have been suggested in prior research as factors that affect CSR activities, and each of these variables was operationalized as a control variable in our model. Owner is a member of board equals 1 otherwise 0, Big hold is the percentage of the company's share that are owned by biggest shareholder. DA is the absolute value of discretionary accruals. ROA calculate net income divided by total asst. Size is measured as the natural logarithm of total assets. Large firms have economy of scale and more external shareholders and thus more likely to promote profitability to respect relationship with related parties. Leverage is computed as the ratio of total debt divided by total assets, is included to measure the level of financial pressure.

The sample selected for this study comprises the listed 336 Korean firms in 2013, which satisfy the following selection criteria: 1. fiscal year ended December 31, 2. firms in non-financial industry, and 3. unqualified audit opinion.

To test our hypothesis on the relationship between stock option and the CSR activities, we estimated the following model. The subscripts I and t represent firm and time, respectively.

$$CSR_{it} = \beta_0 + \beta_1 Option_{it} + \beta_2 Owner_{it} + \beta_3 Bighold_{it} + \beta_4 DA_{it} +$$

$$\beta_5 ROA_{it} + \beta_6 Size_{it} + \beta_7 Lev_{it} + e_{it}$$

CSR : KEJI index score

Option: If the management have stock option is 1, otherwise 0 at year t

Owner: Equals 1 when firm i's owner is a member of board and 0 otherwise at year t

Bighold: Percentage of common shares held by biggest investors at year t

DA: Firm i's the absolute value of discretionary accruals at year t

ROA: Firm i's net income/ total asset at year t

Size: Firm i's natural logarithm of total asset at year t

Lev: Firm i's the debt/total asset at year t

4. Empirical Results

Table 1 shows descriptive statistics for the variables used in this study. Our sample contains 336 firms in 2013. It reports means, medians, standard deviations, and minimum and maximum values. The CSR variable, show a mean and median value 45.540 and 45.402. Stock option (Option) variable, show a mean value 0.170 on a scale between 1 and 0. 17% of sample firms is use stock option as an executive compensation. Mean value of the ownership (Owner) dummy variable is 0.485. It means about 48.5% of the sample firms have owner management. Many founder or owner is a member of board of director in Korean firms like Chaebol. So standard deviation of this is relatively high. The mean and median of the biggest stakeholder (Big hold) are 0.301 and 0.291, respectively. Biggest stakeholder, on average, own 30.1% of outstanding shares. In terms of financial data, the average firm in the sample has discretionary accruals (DA) of about 0.071. ROA of about 0.085, with asset of about 26.677, and leverage ratio of 90.985.

Table 1. Descriptive Statistics

	N	Mean	Median	Std.D	Min	Max
CSR	336	45.540	45.402	3.386	37.350	56.265
Option	336	0.170	0.000	0.376	0.000	1.000
Owner	336	0.485	0.000	0.501	0.000	1.000
Bighold	336	0.301	0.291	0.142	0.050	0.790
DA	336	0.071	0.043	0.097	0.000	0.497
ROA	336	0.085	0.057	0.094	-0.046	0.484
Size	336	26.677	26.397	1.438	23.208	32.086
Lev	336	90.981	71.536	81.919	1.010	610.688

Table 2. Correlations

	CSR	Option	Owner	Big hold	DA	ROA	Size	Lev
CSR	1	0.179***	0.048***	-0.003***	-0.084***	0.149***	0.415***	-0.183***
Option	0.162***	1	-0.010***	-0.017***	0.026***	-0.013***	0.180***	0.033***
Owner	0.039***	-0.010***	1	-0.115***	-0.079***	-0.014***	-0.001***	0.000***
Bighold	0.020***	-0.016***	-0.112***	1	0.030***	0.072***	-0.099***	0.019***
DA	-0.092***	0.001***	-0.087***	-0.001***	1	0.052***	-0.002***	.146***
ROA	0.254***	0.043***	0.028***	0.087***	0.065***	1	-0.012***	-0.087***
Size	0.399***	0.117***	-0.004***	-0.076***	-0.098***	0.038***	1	0.250***
Lev	-0.241***	-0.008***	-0.004***	0.007***	0.094***	-0.146***	0.167***	1

*, **, *** are statistically significant at the 10%, 5% and 1% levels.

Table 2 shows the Pearson's correlation coefficient for the variables. Most of the variables are significant at the level of 1%. The main dependent variables CSR was found to be significantly correlated with the rest of variables. For example, CSR was found to be positively correlated with stock option, owner, ROA, and size but negatively correlated Big hold, DA and leverage.

Table 3. Regression result

Variables	CSR
intercept	15.8766***
Option	0.9686***
Owner	0.3580
Bighold	1.1698
DA	-1.7000
ROA	4.7331***
Size	1.1160***
Lev	-0.0119***
N	336
R ²	0.295
Adjusted R ²	0.279
F-value	19.562***

*, **, *** are statistically significant at the 10%, 5% and 1% levels.

Table 3 provides a regression result. We examine the relation between stock option and CSR activities and various controls for firm specific variables in a multivariate setting using cross sectional models. The dependent variables is CSR activities. The independent variable is stock option dummy and firm specific factors affecting CSR activities. In the regression model reports the analysis of the relationship between stock option and CSR. There is a positive relation between Option variable and CSR, which is statistically significant. The results also suggest that ROA and Size are positively related to CSR, which is significant at 1% level. We also find that Lev is negatively related to CSR. Firms with stock option

compensation tend to have higher CSR activities. The coefficients on control variables are generally consistent with past studies.

5. Discussion

The purpose of this paper is to investigate the impact of stock option grants on CSR activities using a large sample of Korean firms. We have developed and tested a hypothesis based on the agency theory and stakeholder theory. Our paper focuses on the motivation behind CSR activities. We expect firms that compensate executives with long term incentives to be more socially responsible than firms that do not. Our results show that the structure of executive compensation could be used as an effective tool to encourage management to undertake socially responsible actions, in turn resulting in more socially responsible firms. The findings also demonstrate that the structure of executive compensation plays a vital role in influencing executives' focus on CSR, especially the use of contingent compensation such as stock options.

Furthermore, executives who receive stock options are more likely to take actions consistent with maximizing the interests of the firm in the longer term. If the capital markets recognize the advantage of pursuing longer term goals, both stock price and executive's self-interest would benefit from firms that pursue CSR. Our findings also highlight firms' CSR policies and practices. Institutional factors with different executive compensation plans may be valuable in understanding how an environment that encourages higher levels of CSR activities can be nurtured. Our study presents several avenues for future research. Going forward, research covering the attitude of the Board and personal CSR interest of executives could help moderate the association between executive compensation and CSR activities.

6. References

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