INTEGRATING ESG INTO INCENTIVES

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We communicate reality: that is the myth; that is what people believe. It is even what most of us believe. And, in a sense, we do communicate reality. There is something there: bricks and people and so on. And the organization can, say, be ‘doing well’, or ‘doing badly’, in whatever sense you take that to mean. And it is our job to convey it. But what is ‘the full picture’? There is no full picture. We make the picture. That is what gives us our power: people think and act on the basis of that picture! Do you see? Are you beginning to see? (Hines, 1988, p. 254)

Sustainability, environmental impact assessments, diversity and inclusion metrics, affirmative action, corporate social responsibility, responsible investing. Although relatively recent in their adoption, these now-familiar items top the agendas of corporations, institutions and governments globally. But how do we measure them? Who are we measuring them for? What exactly are we measuring? Who defines what ‘good’ performance looks like? How will companies be held accountable for ‘bad’ performance? These questions both shape the environmental, social and governance (ESG) space and blur its boundaries. As corporations, standard setters and institutional investors clarify what—and who—ESG is concerned with, a path is being cleared toward the vanguard of corporate decision-making. Arriving at this precipice – where ESG is still more aspirational than operational – executives are faced with resource allocation decisions. Integrating ESG metrics into incentive systems directs executive attention, and ultimately the time and resources needed to operationalize ESG goals. This is an inflection point; the ways in which we decide to shape and integrate ESG define a system of valuation directed by corporate interests and responsibilities. Decisions we make today frame the picture of our future, begging the question: what do we want it to look like?

ESG THEN AND NOW

Although responsible investing principles date back hundreds of years, their uptake in recent years is unprecedented. In biblical times, Jewish and Methodist churches set out strict guidelines for ethical investment (Schueth, 2003). Throughout the 19th and early 20th century, ethical investment principles were developed among many different institutions but lacked common terminology until the 1950s and 1960s, when socially responsible investing (SRI) rose in opposition to apartheid in South Africa and against the Vietnam War in the 1970s (von Willis & Klein, 2015). The first official SRI mutual fund in the United States, Pax World Fund, was founded in 1971 (Sucher, Beyersdorfer & Cornell, 2012). Since the 1990s, SRI assets under management (AUM) have expanded immensely. The United States now boasts over 250 mutual funds adhering to SRI principles (Sucher, Beyersdorfer & Cornell, 2020).

In Canada, the Responsible Investment Association (RIA) recorded an increase from $456 billion AUM using ESG integration in 2006 to $2,132 billion—just over half of all Canadian assets under professional management—in 2018. The rapidity of growth can, in part, be attributed to the several high-profile environmental disasters which punctuated the dawn of the 21st century alongside dramatically increased frequency of flooding, droughts, heat waves, and windstorms.
In Europe alone over 100 floods occurred between 1998 and 2004, killed 700 people and caused more than US$31 billion in insured economic losses (European Commission, 2019). Changing climatic conditions were widely identified as the cause of these disasters. In response, insurance companies and financial institutions began to prioritize environmental risk management in revised guidelines (Sharma, 2006).

As the number of private, institutional and individual investors grew to keep pace with increasing AUMs, the need for a new kind of reporting emerged. Enter ESG. In 2004, joint efforts by the United Nations (UN) and twenty financial institutions across nine countries produced a report entitled *Who Cares Wins*. The report centred on the notion that risk to long-term profitability was most effectively managed through strategies aimed at ameliorating environmental, social, and corporate governance issues (IFC, 2004). In fostering a broader discussion around sustainable development and social responsibility rather than prescriptive plans of action, *Who Cares Wins* addressed a wide range of actors; analysts, financial institutions, companies, investors, pension fund trustees, consultants and financial advisers, regulators, stock exchanges, and non-governmental organizations (NGOs). Each was encouraged to prioritize ESG principles to ensure long-term asset viability (IFC, 2004). The IFC report introduced clear principles for corporations and institutions to adopt, but reporting practices lacked clarity.

Shortly after the publication of *Who Cares Wins*, the United Nations launched the Principles for Responsible Investment (UNEP) in 2006. The initiative provided a framework consisting of six principles—centred around implementing ESG considerations into investment decisions as well as encouraging others to do the same—for individuals or corporations looking to engage in responsible investing (UNEP, 2020). The success of UNPRI in disseminating responsible investment principles among corporations, asset managers, and investors is evident; what began as 63 signatories and $6.5 trillion AUM in 2006 has ballooned to over 3000 signatories and $100 trillion AUM as of 2020 (UNEP, 2020). The UNPRI institutes strict reporting practices which can lead to signatories being dropped if they fail to adhere to the six principles. Although a poor score can dramatically affect an asset manager’s ability to find and retain clients, the UNPRI is not a regulatory body and therefore does not have any official authority over reporting practices.

While the intent here is certainly not to argue for standardised ESG reporting across all industries, the emphasis placed on financial reporting throughout the history of the corporation necessitates a careful consideration of the ways in which current ESG reporting practices—largely voluntary, metric-driven and subject to great variation between firms—shape and define the scope of environmental and social concerns in a way that continues to privilege shareholder primacy over and above the stakeholders it claims to benefit. As we pass the 50th anniversary of Friedman’s article on the social responsibility of business (Friedman, 1970), it is growing increasingly clear that pursuing profit maximization above all else poses a threat to humanity so great that waiting another 50 years to act ensures our own demise. Our reporting practices fundamentally shape what—and who—we value; recognizing this creates opportunity. This paper is a call to action.
REPORTING FOR WHO?

For much of recent history, financial reporting has been concerned with capital flows and valuation. In fact, the Financial Accounting Standard Board’s (FASB) 1978 Conceptual Framework—responsible for shaping much of what we understand about financial reporting standards today—outlines that ‘assets, liabilities, and owner’s equity of the entity should be expressed in financial terms. Accounting for non-financial assets is limited because there are generally no markers or good valuation techniques available’ (Haskin & Burke, 2016, p. 53). These guidelines are perhaps not surprising given Friedman’s (1970) discourse-shaping, titular assertion that ‘the social responsibility of business is to increase its profits’.

When profit maximization rose to the top of corporate agendas, we constructed a discursive narrative in which shareholders were cemented as both the sole users of financial reports as well as the sole actors requiring attention in corporate decision-making processes.

In placing shareholders in this position, we gave legitimacy to the prioritization of financial reporting at the expense of non-financial considerations and multiple stakeholders.

Through the acceptance of shareholder primacy and dominant financial reporting standards, we join much of our accounting world in assuming this as natural. In doing so, we—problematically—engage in a process of ‘making up users’ (Young, 2006). If our goal is to (re)develop reporting standards which are able to consider multiple stakeholders, understanding the users of financial reports as being of our own construction is an essential first step. Returning to Hines’ (1988) idea that as accountants, we construct reality through our communication of it, it becomes clear that reporting standards—and the organizations who set them—‘work by depicting the user as being of a particular kind and employing this depiction as a justification for its various accounting choices’ (Young, 2006, p. 580). This ‘particular kind’ of user is largely imagined to be a rational economic actor who values only the reporting of information significant to corporate profits, in turn justifying the decision of standards-setting organizations to narrow the focus of financial reporting at the expense of other stakeholders.

As standardized financial reporting percolated throughout corporations across the globe, the need arose for official accounting standards. In 2005, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) agreed to converge their standards wherever possible in order to achieve consistency in reporting frameworks internationally (Benston, Browmwich & Wagenhofer, 2006). This meant not only ease of comparability among corporations for potential investors, but also the global entrenchment of shareholder primacy through official standard-setting bodies. The problem here arises when we consider the foundation and development of the Sustainable Accounting Standards Board (SASB), the organization responsible for the development of ESG reporting standards. When the SASB released its Conceptual Framework in 2013, it adopted a similar approach to that of the FASB and consequently, shaped the reporting framework to be one of metrics and indicators (Haskin & Burke, 2016). This decision was made in order to ensure investors have the ‘total mix’ (Haskin & Burke, 2016) of information necessary without challenging assumptions regarding who uses financial reports. Without challenging these assumptions, ESG reporting runs the risk of perpetuating ideas of shareholder primacy at the expense of other stakeholders.

Paradoxically, the development of a reporting framework which would consider multiple stakeholders took place within the context of a pre-existing structure designed to privilege shareholders. Inside this framework, ESG reporting, and social accounting more broadly, are continually up against a serious agency problem – ‘who has the capacity to act, with whom and in what form of coordination, on what object and in what perimeter, what activities does that entail?’
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(Feger & Mermet, 2017, p. 1515). ESG reporting and the implementation of measures that effectively engage with ESG issues display clearly the problem of collective action (Olson, 1965); to be effective in advancing ESG reporting in any meaningful way is to locate among multiple stakeholders, shareholders, employees, and the environment a common good which does not currently exist. The corporation’s ESG reporting (what it says), therefore, is fundamentally at odds with its actions (what it does). This display of ‘organized hypocrisy’ (Brunsson, 2007) is not surprising, given that the entirety of social accounting was developed to be used by rational economic actors (Gray, 2006; Young, 2006). It would, therefore, be naïve to believe that attempts to flatten the world and ‘prioritize’ multiple stakeholders would be of any real consequence without a dramatic shift in financial reporting practices.

WHO DECIDES?

Underlying our discussion surrounding the actual contents of ESG reporting is the assertion that all corporate reporting is both a reflection of corporate values and a means of legitimizing corporate decision-making. The extent to which this process can be understood as a construction of reality is further complicated by the fact that most ESG reporting occurs voluntarily with little guidance—especially with respect to social issues—on what is to be included, how measurements are taken and importantly, why disclosure decisions are made (Adams, 2002; Wilmhurst & Frost, 2000). Social enterprises (SEs) have made attempts in recent years to combat the ambiguity of voluntary reporting through social impact assessments (SIAs). Although still voluntary, these assessments typically burden corporations who choose to undertake them. This is because the reporting is time consuming and costly to carry out, but provides a means of scoring financial sustainability in a way not possible through traditional financial reporting (Nguyen et al., 2015).

On the other hand, SIAs face legitimacy concerns, and often corporations turn to adopting concrete metrics by which to score performance (Nicholls, 2009). As accountants, it is unlikely for us to see anything wrong with this. However, the practice of adopting financial reporting practices to assess social and environmental issues speaks not only to the limitations created by our existing systems of valuation, but also to the ways in which social reporting practices are co-opted for purposes other than fulfilling the corporation’s responsibility to multiple stakeholders. In the same vein, Fallan and Fallan (2009) argue disclosures through voluntary channels are often employed as a legitimacy device rather than as a method of ensuring accountability. To this end, it would appear that ESG reporting decisions are of little consequence to those making them when social accountability is obfuscated by economic and reputational considerations.

Indeed, voluntary reporting is a tool designed and employed in the name of value creation (Gray, 2006). Herein lies the crux of the issue: social accounting espouses a desire to reform corporate values, yet businesses expend a great deal of energy to maintain it as a ‘discretionary and voluntary activity whilst promoting a rhetoric which supports the general lack of importance of social accounting; the cherry-picking partiality of current reporting practices versus the claims that business and government make for that reporting’ (Gray, 2006, p. 803). By allowing corporate actors to retain control over disclosure decisions, they possess the power to further shape what—and who— society values.
INCENTIVIZING ATTENTION

Thus far, the critical examination of ESG reporting has helped us to understand the role of reporting, who it benefits and who it does not. When we turn to an examination of the metrics we choose to include in reporting, we can draw a parallel; in placing boundaries around what we decide to measure, we also decide who counts and who does not, who remains visible and who disappears from our balance sheets, tables and figures.

If we aspire to effectively account for social impacts using ESG reporting mechanisms as they currently exist, it is essential to ask ourselves: how do we ascribe value to conservation efforts? To human lives? To employee welfare? Once these concerns are accounted for, to whom are corporations accountable?

In making attempts to apply liberal market logic to environmental and social issues, ‘any process of valuation seems to be constrained to conform to the convention that money is its natural language, and, therefore appropriate for adoption and use by all stakeholders’ (Funtowicz & Ravetz, 1994, p. 198). Choosing an operational definition for value fundamentally shapes how we treat one consideration in relation to another; if we accept money as our unit of exchange, accounting, reporting, and disclosure are the institutional practices through which value is defined and reified.

The dominant logic of metrification and quantification has influenced the centrality of environmental reporting in most reports. This may, in part, be due to the fact that environmental impact measures are easier to evaluate quantitatively, and therefore carry more weight because of the ways in which reporting practices both conceptualize and create value (Gray, 2006). Social measurements, as discussed in the context of SIAs, are time-consuming and difficult to quantify without compromising the integrity of what it would mean to actually report on social issues for the benefit of multiple stakeholders.

Beyond addressing the difficulties in measuring impact and the limits imposed by metrification, it is our imperative to think about our reporting practices as much more than financial statements and ESG targets. Our reporting practices capture a firm’s state of affairs, painting a picture that is often considered as an immutable moment, fixed in time. Yet, quarter to quarter and year to year, these reports document changes in priorities, leadership and areas of focus. Exactly how these reports transform ESG intentions and goals into the substance of action has yet to be resolved.

One of the avenues by which this shift can occur is through embedding ESG metrics into executive incentive contracts. In 2012, the PRI in collaboration with Global Compact LEAD (a leadership platform within the UN Global Compact) published guidance for investors and companies on the integration of ESG metrics into executive pay. The initiative was focused on executive management goals and incentive schemes, and provided guidance on how to identify metrics, link them to pay, and provide disclosure on such practices. Four years later, the PRI published a follow up report noting that integration of ESG metrics into executive pay remained in its infancy; ‘hindered by the lack of a universally accepted standard of reference’ (PRI, 2016) to assess ESG risks and opportunities. The report also alluded to other challenges related to the governance of executive pay: lengthy and complex compensation reports, informational needs for setting and evaluating metrics, disclosure necessary to observe pay for performance linkages. Yet, these challenges pale in comparison to the moral panic which has settled on executive pay practices in recent decades. Public vitriol found its voice in social movements such as the Occupy movement, while political and regulatory action has taken shape most notably in the form of say on pay regulation. At the risk of embroiling ESG concerns within the controversies of executive pay, it is worth considering the underlying mechanisms which shape the design, determination and governance of executive compensation contracts, and the opportunities which this may present for corporate ESG agendas going forward.
THE RISE OF EXECUTIVE COMPENSATION

The emergence of executive compensation contracts followed the rise of professional managers in corporate North America. From the 1920s, America’s largest companies were introducing novel incentive systems for their burgeoning class of professional managers. Du Pont and General Motors (GM) were the first to introduce stock-based compensation (Holden, 2005). These compensation practices preceded the highly influential work of Berle and Means (1932), yet encapsulated the central thesis: agency problems were anticipated when managers were no longer the sole or majority owners of the company. Berle and Means (1932) had observed that control of the firm was “in large measure apart from ownership” and professional managers had “almost complete discretion in management” (p.139). Such discretion would need to be reined in to ensure alignment with owners’ interests. Jensen and Meckling (1976) furthered this line of thinking by suggesting that companies formulate the optimal contract for eventual superior performance, thereby correcting for the owners’ inability to monitor the executive’s actions. This attention to the bargaining and monitoring power of the contract catalyzed new avenues for research based on optimal contracting theory. These optimal or efficient contracting scholars (Murphy, 1999)—from disciplines including accounting, economics, finance and management—sought to identify the determinants of pay and/or evaluate the linkages between pay and performance. While researchers agree that executive pay is largely determined by firm size and firm complexity, ‘the failure to document a consistent and robust relationship between executive pay and firm performance has frustrated scholars and practitioners for over three quarters of a century’ (Devers et al., 2007, p. 1016). This is perhaps unsurprising when we consider that a historical examination of incentives reveals ties to political control and power of both the persuasive and coercive nature (Grant, 2002).

Executive compensation research had been inattentive to the social and political contexts in which executive pay was designed, determined and governed. Bebchuk and Fried (2003, 2004) provoked researchers and practitioners alike to consider that executive pay practices might be captive to power imbalances between boards and executives. A second wave of research demonstrated that executive pay is shaped by a host of factors, including corporate governance (or lack thereof), social norms, the market for corporate control, and the labor market for executives (Bebchuk, Fried & Walker 2002, Bebchuk & Fried 2004, Piketty & Saez, 2006). In drawing attention to the social and political determinants of pay, Think tanks, activists, politicians and academics have drawn our attention to the outsized increase in executive compensation in recent decades, and its implications for the ever-widening chasm between the top 1% of earners and the rest of society. For far too long, a line has been drawn in the sand between the market logics of pay setting and the moral implications of executive pay. This is a false divide. We must draw our attention to the moral and political nature of pay.

Pay-for-performance based on metrics designed to reflect what a firm—or the investor—values means that these incentive schemes do not reflect the dominant logic of trade producing mutual benefit, but rather, are moral issues.

When the creation and implementation of incentive schemes contributes to rising inequality, while at the same time works to shift the focus of attention, it is essential we recognize the power of incentives to define the limits of care.

Although the historical focus on shareholder return has limited the scope of firms’ attention to social and environmental considerations, the centrality of the shareholder—coupled with the ways in which they are ‘made up’—offers an opportunity to imbue corporate attention with new meaning. Recent transformative shifts in the expectations of corporations in society allude to some changes in shareholder priority; the Business Roundtable (2019) recently redefined the purpose of a business; Larry Fink, the CEO of BlackRock (world’s largest asset manager) stated that all companies must prove how they make positive contributions to society. In response to changing priorities, ESG metrics
are emerging as critically important, both as a means of ensuring long-value creation and as a way of redefining the responsibility held by corporations.

Integrating ESG into compensation also creates a unique set of challenges and highlights the tensions inherent in all organizations. While many issues addressed by ESG metrics relate to long-term investments and future value creation, to date, ESG has overwhelmingly been integrated into executive pay as a short-term measure of firm performance. For example, 61% of TSX 200 companies disclosed the use of ESG metrics in their executive compensation plans, however, only 2.5% (five companies) integrated these metrics into their long-term incentive packages. Beyond the concern of short versus long term horizons, there is also a question of quantitative versus qualitative metrics. A study by Maas (2018) found that integrating quantitative, 'hard' corporate social performance (CSP) targets into executive contracts are effective in improving CSP, particularly compared to qualitative, 'soft' targets. This has, for example, implications for our society’s current and increasing concerns around Diversity and Inclusion, for example. Where there is the will, 'hard' diversity metrics are easy enough to formulate but meaningful inclusion and the corporate culture it relies upon cannot be so easily reduced.

Herein lies the conundrum of social issues and concerns; ours is a society with a penchant for quantification and metrification, requiring measurement and recording to produce action, yet shifting corporate culture relies on more than 'hard' targets will allow. How do we measure inclusion? How do we account for the loss of biodiversity? What kind of value can we ascribe to the survival of our natural world?

When it comes to ESG and executive compensation, the lack of clear definition surrounding that which should be contained in social reporting has far-reaching implications. The tension at the intersection of ESG and incentive systems forces us to question not only what is good for the individual, but what is good for the firm and society at large. It creates an opportunity to redefine systems of value that reflect a reality in which corporate responsibility does not begin and end with shareholders and profit maximization. It offers the potential to direct managerial attention beyond the bottom line. Integrating ESG into executive compensation makes a statement about the importance of constructing a more equitable reality. Present decisions surrounding ESG reporting are ones of true responsibility. Our reporting mechanisms ascribe value to human lives and the natural world. What we value defines the boundaries of what we account for. Once those boundaries have been defined, attention can be directed, and accountability can be located.

Do you see? Are you beginning to see?
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