LEANNE KEDDIE

Rewarding good behaviour

What do executive pay and corporate social responsibility (CSR) have in common? Leanne Keddie, a PhD candidate in accountancy at Concordia University in Montreal, received a Bertram Scholarship for her research on the use of CSR performance-based incentives in executive compensation packages. The awards are made annually by the Canadian Foundation for Governance Research, which is backed by the Institute of Corporate Directors, and are based on the belief that research is vital for fostering knowledge about governance and putting into practice evidence-based recommendations. Keddie explains that the use of CSR performance-based incentives is on the rise, but the implications of the practice are still unclear.

While executive compensation and corporate social responsibility might seem like concepts that are miles apart, they connect in an unexpected place: executive bonus plans. Roughly 40 per cent of companies in the S&P 500 are linking executive compensation to some level of CSR performance. Traditionally, executive compensation has been tightly connected to shareholder value, and consequently performance pay goals have typically related to financial measures such as earnings per share or total shareholder return. Some years ago, companies began including various non-financial metrics, such as customer satisfaction, in executive compensation packages. However, this broader set of metrics arguably is still meant to lead back to improved financial performance.

Today, we are seeing increasing use of CSR performance-based incentives in executive pay packages that specifically target social and environmental objectives. For example, 20 per cent of Royal Dutch Shell's 2016 short-term incentive plan (STIP) was tied to sustainable-development goals. This may indicate a shift in the focus of big business to incorporate a broader set of stakeholders. It is still unclear, however, whether companies expect CSR incentives to improve financial performance, although research shows that improved CSR performance can lead to better financial performance. (It is important to note that there are different types of CSR performance. Reducing greenhouse gas emissions or increasing diversity are examples of measurable performance; adopting a fair remuneration policy, on the other hand, is intangible and, depending on how it is implemented, may or may not result in improved measurable performance.)

Providing CSR incentives to management may provide the board of directors with a tool to improve an organization's CSR performance. Accordingly, it is important for boards to gain a better understanding of what CSR incentives are all about. Boards interested in engaging with stakeholders and improving communication must understand how CSR incentives are used and what makes them effective.

CSR INCENTIVES TAKE MANY FORMS

Businesses are using CSR performance-based incentives today mainly in STIPs as a way to connect executive pay to a perceived definition of corporate sustainability, one that includes financial, social and environmental considerations. STIPs offer executives liquidity, providing them with cash compensation typically making up about 20 per cent of their annual compensation.

My research finds that among companies offering CSR incentives, roughly 60 per cent include only social goals. These may refer to employee safety or diversity initiatives. Eight per cent of firms provide only environmental goals. These may include pursuing clean energy initiatives or reducing greenhouse gas emissions. The remaining 32 per cent include both social and environmental incentives. Like the Royal Dutch Shell example above, some enterprises explicitly refer to sustainability. Others include both social and environmental goals in the STIP. CSR performance-based incentives typically drive between 10 per cent and 30 per cent of a total target bonus amount.

While some of the original research on CSR performance-based incentives found adoption to be most common in industries such as oil and gas or mining, my research finds that they have spread to other industries, including telecommunications, financial services and pharmaceuticals. Forty-two per cent of companies providing CSR performance-based incentives do so with formal goals. Another 41 per cent do not include explicit targets in the STIP but discuss the role that specific social and environmental considerations played in determining the award granted. Roughly 14 per cent of boards use these incentives as a modifier. For example, the board determines the STIP award based on explicit goals but increases or decreases this amount based on its assessment of relevant sustainability information. A small percentage of firms use these incentives solely as a negative modifier to reduce STIP awards when there is poor CSR performance and provide no upside potential for good performance.

WHAT BOARDS NEED TO KNOW

We are just beginning to understand the implications of including CSR performance-based incentives in executive compensation packages. My research investigates why businesses adopt CSR performance-based incentives and how they affect performance, how corporate governance plays a role and who is affecting this process. I consider how various stakeholders interact with a company to influence the inclusion of these incentives in executive pay packages.

In his most recent annual letter to business leaders, BlackRock CEO Larry Fink called for greater attention to climate change and corporate sustainability. It's possible that pressure from institutional shareholders is changing the way companies handle sustainability issues. It's also possible that the adoption of these incentives is management driven, or that businesses feel pressure to follow their peers who adopt similar measures. Regardless, these incentives may provide a visible way to communicate a firm's sustainability initiatives to shareholders and other stakeholders, but boards must get the design right.

I believe that in better understanding how companies are using CSR performance-based incentives, we can identify which practices work well and which do not. I plan to document the effect these incentives have on businesses' CSR performance and financial performance, allowing a more nuanced understanding of the practice. Those firms that are keen to embrace corporate sustainability will be able to better design executive compensation plans and to communicate the benefits to stakeholders. In addition, this research should be valuable to shareholders demonstrating a growing interest in both executive compensation and social and environmental matters – issues of great importance in corporate governance today. Over all, we all benefit from understanding why CSR performance-based incentives are offered, how corporate governance plays a role and what effect these incentives have.