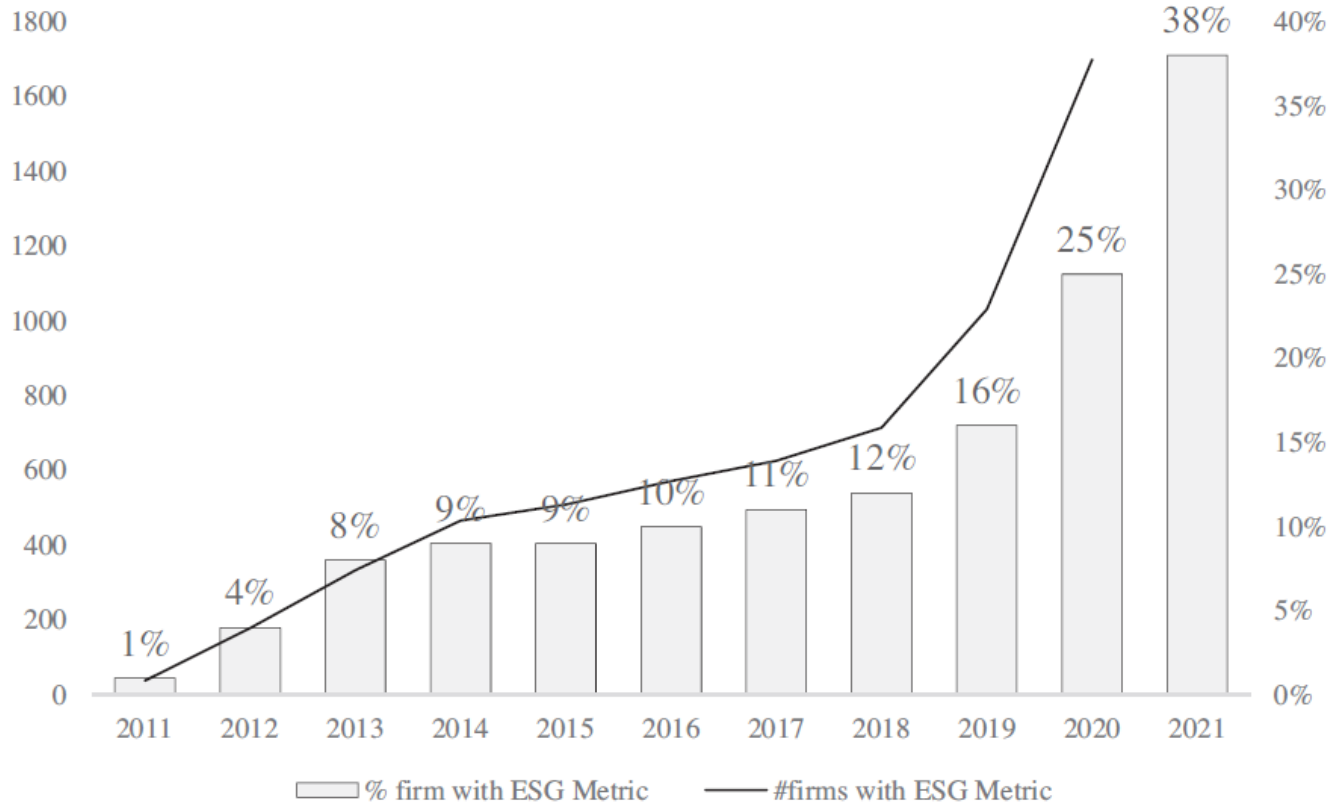


Corporate Purpose, Measurement, and Performance

Gaizka Ormazabal, IESE Business School, CEPR, ECGI

Modern Capitalism and Corporate Purpose
ECGI & Copenhagen Business School, September 2023

Linking Compensation to ESG









Source: Cohen, Ormazabal, Kadach, Reichelstein, JAR 2023

Linking Compensation to ESG

Shor-term (annual)	Long-term (multi-annual)
40% Group organic sales growth	40% improvement EPS
30% Adjusted EBITDA (organic) improvement	35% TSR (2 benchmarks)
10% Group cash conversion rate	
20% Schneider Sustainability Impact	25% Four (external) ESG Ratings

Linking Compensation to ESG

Schneider Sustainability Impact 2021-2025	
Long-term Commitments	2021-2025 SSI programs
<p>Act for a climate positive world</p> 	<ol style="list-style-type: none"> 1. Grow our green revenues to 80% 2. Deliver 800 million tons of saved and avoided CO₂ emissions to our customers 3. Reduce CO₂ emissions from top 1000 suppliers' operations by 50%
<p>Be efficient with resources</p> 	<ol style="list-style-type: none"> 4. Increase green material content in our products to 50% 5. 100% of our primary and secondary packaging is free from single-use plastic and uses recycled cardboard
<p>Live up to our principles of Trust</p> 	<ol style="list-style-type: none"> 6. 100% of our strategic suppliers provide decent work to their employees 7. Measure the level of confidence of our employees to report behaviors against our principles of Trust
<p>Create equal opportunities</p> 	<ol style="list-style-type: none"> 8. Increase gender diversity, from hiring to front-line managers and leadership teams (50/40/30) 9. Provide access to green electricity to 50 million people
<p>Harness the power of all generations</p> 	<ol style="list-style-type: none"> 10. Create opportunities for the next generation – 2X number of opportunities for interns, apprentices, and fresh graduate hires 11. Train 1 million underprivileged people in energy management
<p>Empower local communities</p> 	<ol style="list-style-type: none"> 12. 100% of Country and Zone Presidents define 3 local commitments that impact their communities in line with our sustainability transformation

Linking Compensation to ESG

NO

1. Skepticism about ESG

- “I’m skeptical about climate risk”
- “I don’t know what ESG means”
- “It’s the Government’s job”
- “I can’t afford it”

2. “I believe in ESG but not in ESG Pay”

- “ESG is a must”
- “We don’t need a bonus to incent ESG”
- “ESG metrics are too noisy”
- “The financial metrics do the job”

YES

1. Performance measurement

- Financial metrics have limitations
- ESG metrics can give additional information

2. Aligning with ESG preferences

- Some shareholders are ready to earn lower returns to improve ESG
- Give in to pressure from stakeholders
- Necessary to go the “extra mile”

3. “Signaling”

- Gives credibility to public commitments

Linking Compensation to ESG

FINANCIAL TIMES

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Executive Pay [+ Add to myFT](#)

Investors warn 'fluffy' ESG metrics are being gamed to boost bonuses

Majority of S&P 500 companies use environmental, social or governance criteria to guide pay



Southwest Airlines boosted its chief executive's pay last year despite cancelling thousands of flights © Robyn Beck/AFP/Getty Images

Linking Compensation to ESG

Findings in Cohen, Kadach, Ormazabal, Reichelstein (JAR, 2023):

- At least to a certain extent, ESG Pay follows an economic rationale
- ESG is followed by better ESG performance
- ESG is not followed by better financial performance

Integration of ESG into Financial Reporting

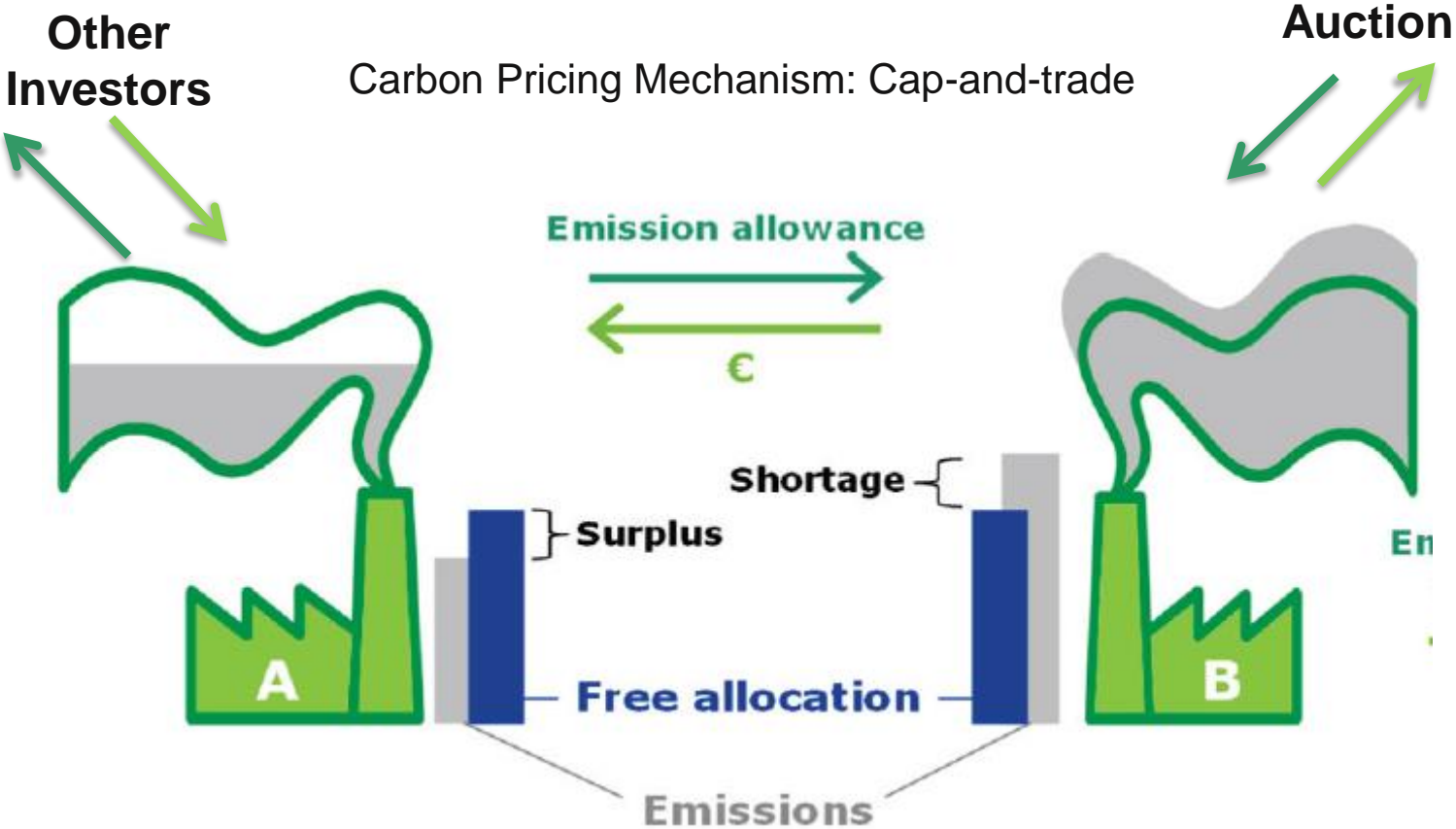
GAAP Topic	Example
Inventory (IAS 2, Topic 330)	A regulatory change that renders inventories obsolete
Intangibles and Goodwill (IAS 38, Topic 350, 20)	An entity may develop a more energy-efficient product to substitute a legacy product, resulting in a change in the estimated useful life of the client relationship intangible asset associated with the legacy product.
PP&E (IAS 16, Topic 360)	A change in regulation that adversely affects an entity could indicate that a manufacturing plant may be impaired
Loss contingencies, environmental obligations, asset retirement obligations, gain contingencies...	Legal obligation to remove a toxic waste storage facility
Income taxes (IAS 12, Topic 740)	Estimates of future taxable income may be affected by projected increases in costs to comply with enacted environmental regulations
Fair value measurements (IFRS 13, Topic 820)	Potential legislation, or an asset's highest and best use, may affect fair value measurements.

Integration of ESG into Financial Reporting

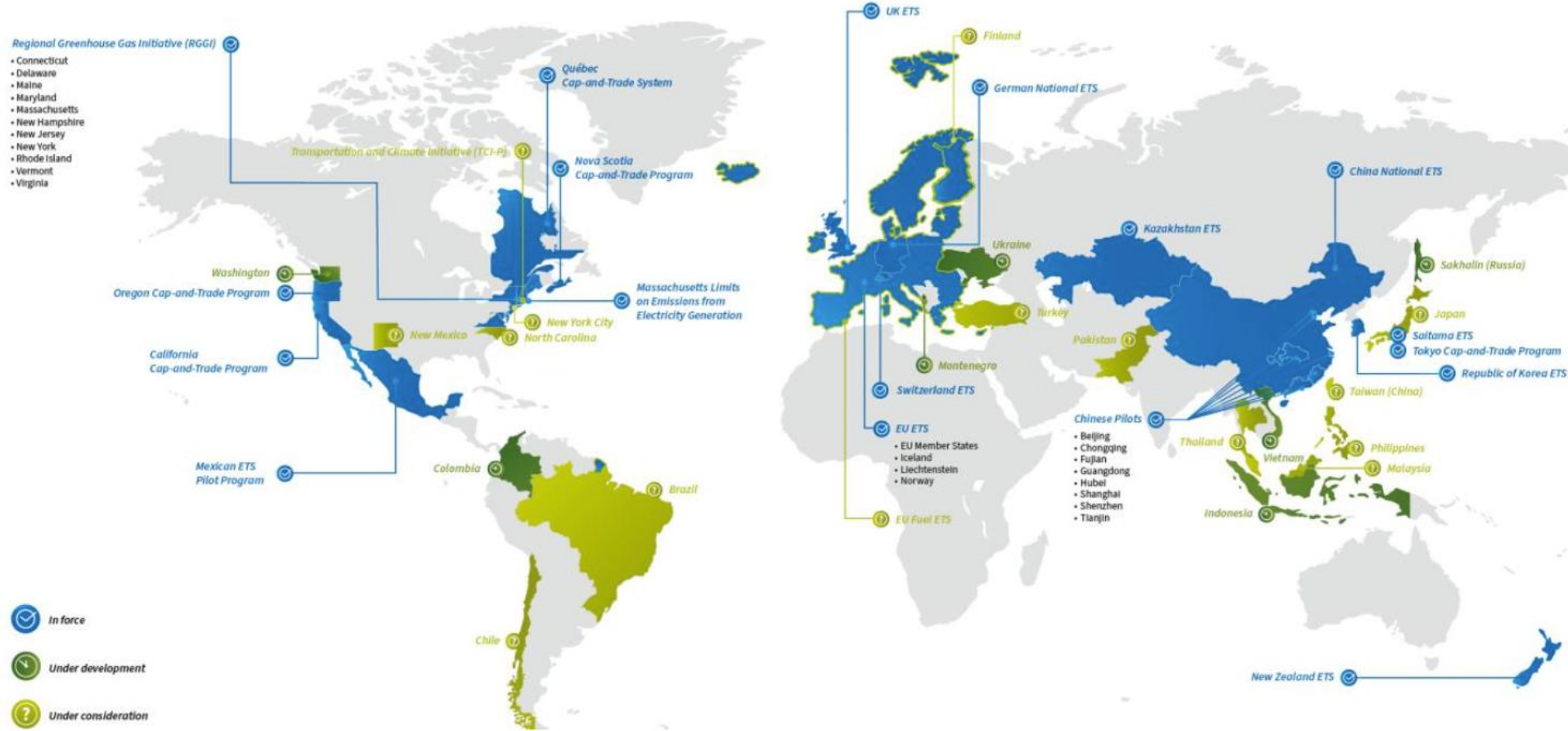
“ESMA highlights that issuers and auditors must consider climate risks when preparing and auditing IFRS financial statements to the extent that the effects of those risks are material to those financial statements, even if IFRS Standards do not explicitly refer to climate-related matters.”

ESMA (the European Securities and Markets Authority), October 2021

Emission Trading Systems



ETS Across the Globe



Accounting for Carbon Allowances

- **What type of asset is an emissions allowance?**
Financial asset? Intangible asset? Inventory?
- **What is the nature of any liability created for a participant in a cap-and-trade ETS?**
Some allowances are government grants (day 1 gain or deferred income?)
The obligation arises only as emissions are made
- **Which measurement approach best reflects the economic effects of emission allowances?**
Fair value or book value?
- **Any “real effects” of the accounting treatment?**
- **Spillovers from financial markets into carbon markets?**

Connectivity between Financial and Sustainability Reporting

What are the friction(s) preventing climate risks from being incorporated into FS?

- **Agency** (i.e., reporting incentives, lack of effort),
- **Regulation** (the current rules are not clear, or make it difficult)
- **Production costs** (some firms do not have enough resources to model/quantify certain things)
- **Knowledge** (we are learning how to do it)