Values Alignment – Management Control beyond ‘Purpose Washing’

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The basic idea …

Management control is about aligning everyone in the organization with organizational goals and values. Alignment is the object of effective management control.

If the organization goes beyond ‘profit’ and ‘shareholder value’ into ‘purpose’ and ‘stakeholder welfare’, then so must management control; otherwise the expanded values will remain good intentions at best, or degrade into ‘purpose washing’ at worst.

My objective …

My talk elaborates, and critically evaluates whether and how management control can effectively calibrate profit and purpose, shareholder wealth and stakeholder welfare, and the tradeoffs involved in aligning the organization with such wider organizational goals and values.

So, basically …

What are the **management control implications** of:

- the [new] emphasis on CSR, ESG, 'corporate purpose' …

  or

- the idea of the pursuit of 'stakeholder welfare maximization'?

Rather than …

'purpose washing'

It is difficult for investors, consumers, regulators, and other stakeholders to assess ESG performance if companies are not transparent and truthful in their ESG disclosures. As a consequence, poor ESG information may adversely affect ESG-oriented stakeholders' decision-making and lead ESG investors to misallocate capital (Baker et al., 2022)

- Green washing
- Social washing
- Diversity washing

Process / maturity …

Compliance

↓

Strategy – **control** - performance

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Quickly, some terms …

Sustainability

- Meet the needs of the present without compromising the needs of future generations
- Subset: often climate-related

ESG (Environmental, Social and Governance)

- Nonfinancial factors about a company that can provide information that is material for regulators, investors, and other stakeholders
- Often used in the context of required disclosures (e.g., for Socially Responsible Investing)

CSR (Corporate Social Responsibility)

- Many definitions (e.g., Dahlsrud, 2006)
- Is probably the broadest term
- Encompasses sustainability and some other important corporate responsibilities

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So, what is …

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Challenging, and conflicting …

[…] Because [ESG] lumps together a dizzying array of objectives, it provides no coherent guide for […] firms to make the tradeoffs that are inevitable in any society. Elon Musk of Tesla is a corporate governance nightmare [bad on 'G'], but by popularizing electric cars he is helping tackle climate change [great on 'E']. Closing down a coal mining firm is good for the climate [and thus good for 'E'] but awful for its suppliers and workers [bad for 'S']. Is it really possible to build vast numbers of wind farms quickly [good for 'E'] without damaging local ecology [bad for 'E' at the same time]?*

* "ESG Should Be Boiled Down to One Simple Measure: Emissions," *The Economist* (July 21, 2022)

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Challenging *and* conflicting indeed …

Monday September 19, 2022 *Esg Scores And Pollution*

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Beyond definitions, measurement …

Can we measure:

- Stakeholder welfare maximization?

  No. It's a theoretical concept

- Overall [CSR] performance?

  Maybe? e.g., six published ratings, but the ratings do not correlate highly

  Average = 0.30; range [-0.12, 0.67] | no "convergent validity" (e.g., Catterji et al., 2015)

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Beyond definitions, measurement …

Can we measure:

- Shareholder value maximization?

  No. It's a theoretical concept too! (But maybe we have better proxies?)

Management control implications …

- *If you can't measure it, you can't manage it*

  [?]

- *If you can't measure what you want, then you want what you can measure*

  [?]

(I will come back to this.)

Implications for managers …

- Unable to judge their successes and failures
- Where performance is poor, unable to discern whether it is due to:
  - Poor [CSR] strategy
  - Poor [CSR] execution

    or
  - Simply poor measurement

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Two important managerial challenges …

[CSR] strategy

- How much to invest in [CSR]?
- How to allocate the investments?

Management control/execution

- How to ensure that the chosen [CSR] programs get implemented as desired?

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[CSR] strategy

- How much to invest in [CSR]?
- How to allocate the investments?

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An important backdrop:
management's mindset ('tone') …

Are environmental and social objectives, or
is 'organizational purpose':

- A corporation's **responsibility** or 'duty'?

  and/or
- A **necessity** for effective (risk) management?

  and/or
- An **opportunity** to "do well by doing good"?

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And against that, a further question is …

Do the [CSR] investments benefit or cost the firm
[*in the short-run*]?

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Some [CSR] activities clearly benefit the firm *in the short-run …*

'win-win' | 'doing well by doing good' | 'synergistic value creation'

- Cut costs
- Exploit competitive advantage
  - Generate additional revenues/profits from differentiated products/new customers (e.g., in renewable energy)
- Enhance reputation
  - With current and potential customers, employees, suppliers, socially responsible investors
  - Create an insurance-like buffer against potential adverse political, regulatory, and social sanctions/penalties

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Other [CSR] activities can have adverse effects on profit and stock price, *at least in the short-run …*

In other words, these firms are motivated to make decisions that are *not* shareholder-wealth maximizing and can be seen as 'transferring' firm resources to non-shareholder stakeholders

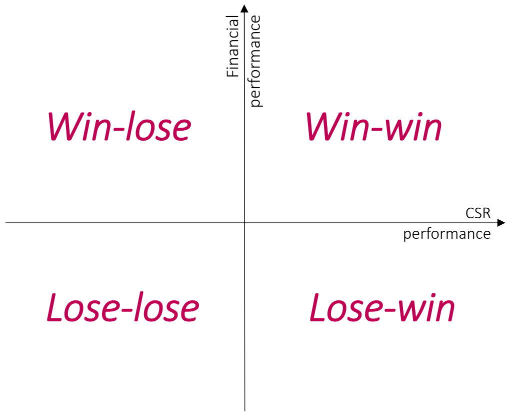
For example:

- Switching to renewable energy sources (if more expensive)
- Responsible sourcing (if more expensive)
- Making contributions to charities (rather than retain earnings)

In the corporate finance tradition, these investments are an 'agency problem'

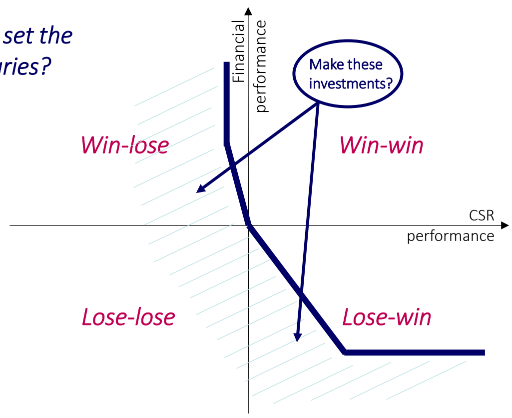
- Alienate investors
- Cause the company to lose focus on shareholders?

Performance tradeoffs: financial v. [CSR] …



Performance tradeoffs: financial v. [CSR] …

Where to set the boundaries?



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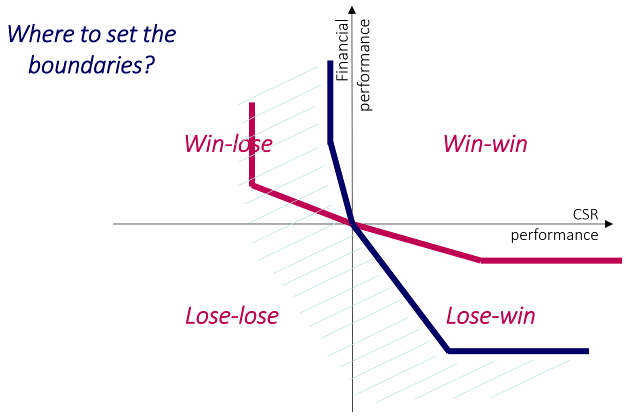
Notice the difference?



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Prioritizing various [CSR] investments …

Managers (should/do?) invest in programs and projects that:

- Promise to provide the greatest economic and [CSR] benefits (‘**win-win**’)
- Are in areas of most direct **relevance** to their business
- Are in areas where greater regulatory, political, or societal **pressure** for performance is being applied
- Have a **champion** within the organization

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Two important managerial challenges …

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- How much to invest in [CSR]?
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[CSR] management control/execution …

Once the choices are made, how to ensure that the [CSR] programs are successful?

- **Result controls**
  - Goals / measures / incentives
- **Action controls**
  - Rules, regulations, audits, enforcements
- **Personnel/cultural controls**
  - Training, passionate CSR people with jawboning rights, organizational culture, tone at the top

Choice of execution approaches …

- It would be nice if all employees were passionate about [CSR] (i.e., **embedded culture**) … but they're not
- **Result controls** ('incentives') can have good effect though may suffer from the common *accountant's trap* …
- **Action controls** will be inevitable, but ideally to provide some additional tightness in a complementary way …

Microsoft

Examples of CSR initiatives

- Carbon neutrality
- Use renewable energy sources
- Lower water usage
- Less waste
- Making Microsoft products "usable, efficient & delightful for disabled people"
- Responsible sourcing
- Data security
- Online safety

Execution strategies

- Goals, measures, incentives
  - Individual
  - Group
- Rules, regulations, codes of conduct (supported by training, audits, discipline)
- Passionate employees with jawboning rights

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Result controls …

Measurement and incentives …

- **Measurement [in]completeness**
  - Problem: **multi-tasking**
  - *Mitigation: **Materiality** of the chosen ESG focus*

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Measurement and incentives …

- **Measurement [im]precision**
  - Problem: **means-end inversion**, **gaming**
  - *Mitigation: **subjectivity***

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Measurement and incentives …

- **Measurement** [**mis**]**alignment,** [**dis**]**synchronicity**
  - Problem: **lose-win**
  - *Mitigation: **selectivity*** (use incentives only when **win-win**)

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Measurement and incentives …

- Other problems:
  - **Sensitivity/ horizon**
  - **Noise/uncontrollability**
  - …

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My view is not …

… that companies shouldn't tie pay to ESG metrics

Instead, the right question is …

… *when* they should or should not

(and when not, rely relatively more on other control types, incl. intrinsic motivation [selection], culture, 'ownership' etc.)

So, then …

- ESG incentives can be appropriate in companies if the above concerns (about completeness, precision, and synchronicity) are muted. For example, in an energy company:
  - Decarbonization is likely much more important than any other stakeholder issue, so there is less of a concern about overweighting a single ESG factor (thereby alleviating the multi-tasking problem)
  - Moreover, there is relatively little disagreement on how to measure direct GHG emissions (which alleviates gaming, improves sensitivity)
  - And, boosting ESG performance is also likely to boost financial performance (thus, a win-win situation)

Why pay managers for doing good; for something they are supposed to do anyway?

Why pay managers for creating shareholder value? Aren't they supposed to do that, too, anyway?