HOW COVID-19 RESHAPES BUSINESSES AND EXECUTIVE PAY FOR SUSTAINABILITY

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Abstract

The purpose of this paper is to answer the research question of how to design a fair and resilient compensation scheme according to stakeholder theory and the sustainability concept. The first finding of this paper is the framework for the sustainable, fair, resilient, scientific, simple, and practical compensation schemes — pay for sustainability (P4S). P4S has been developed after reviewing the literature and obtaining insights from the compensation consultants in Switzerland. It is also a useful tool in COVID-19 and will be for future crises. As a second finding, this theory-adaptation-based conceptual and commentary paper criticizes the conventional executive compensation structure and introduces the business lessons learned from the COVID-19 crisis. As a contribution to both the literature and practice, this research advances the novel knowledge in the field by conceptualizing a reliable and scientific framework and explaining the advantages and disadvantages of the four methods of the P4S framework. During COVID-19, environmental, social, and governance (ESG) based performances and compensation schemes have gained more importance. Finally, these proposed methods contribute to the adaptation of ESG-based compensation schemes while considering the local and individual differences of organizations.

Keywords: COVID-19 (Coronavirus Disease 2019), Pay for Sustainability, Stakeholder Theory, ESG-Based Executive Compensation

1. INTRODUCTION

The coronavirus pandemic (COVID-19) has brought about a paradigm shift in our understanding of business operations, executives’ skills, and sustainability compensation schemes. This theory-adaptation-based conceptual and commentary paper provides a pay-for-sustainability compensation (P4S) framework as a response to the COVID-19 crisis after illuminating business and corporate governance lessons learned during and after COVID-19. A P4S or ESG-based compensation scheme is scientifically, theoretically, and practically developed based upon stakeholder theory, the knowledge gained through the literature review, and the insights obtained from the practitioners. This paper aims to find an answer to the question of how to design a fair and resilient compensation scheme according to stakeholder theory and sustainability concepts.
The P4S and ESG-based compensation schemes will be used interchangeably from this section forward. P4S is a scientific framework with four methods that are conceptualized based upon the theory adaptation research approach, in line with the studies of Jaakkola (2020), Cho and Fiore (2015).

In practice and the literature, there is a need and a gap for establishing a sustainable, fair, and resilient ESG-based compensation framework. Azizuddin (2020), Harvey, Zarghamee, and Ocker (2020) proved that ESG information is material to investors’ decision-making, especially in the post-COVID-19 world, and investors ask for the disclosure of ESG performances and ESG-based compensation schemes in the annual reports. Moreover, previous research (Baralbar-Diez, Odrozola, & Fernandez Sanchez, 2019; Berrone & Gomez-Mejia, 2009a, 2009b) reveals that developing a resilient and fair ESG-based executive compensation scheme has a positive impact on the company’s ESG and financial performances and sustainable performance targets in an executive compensation contract.

Besides, the utilization of sustainability-related targets in an executive compensation contract extrinsically motivates executives to adopt a sincere approach to the firm’s sustainability performance.

Despite investors’ demands for the existence of the ESG-based compensation scheme (Azizuddin, 2020; Harvey et al., 2020; Lee, 2020), previous research has not investigated the methods of pay for sustainability. Thus, this paper aims to fill this gap in the literature by introducing the four methods of P4S and comparing the advantages and disadvantages of each method while considering the individual and local differences of the organizations.

Furthermore, this paper takes the argument of the performance of the ESG-based compensation framework and tries to start a debate on the ESG-based compensation frameworks. This debate opens doors for future research avenues regarding the simple, holistic, scientifically driven sustainable executive compensation framework or method, and motivates boards to reward sustainability performance at the top. It helps to create socially legitimate, fair, resilient organizations, and contribute to a stable economy. In addition to its practical and academic implications, it has political implications, since the suggested framework and the aforementioned investors’ demands may persuade the policy-makers to introduce principle-based rules for sustainable compensation schemes.

The remainder of the paper is structured as follows. Section 2 reviews the literature, including the concepts of sustainability, ESG, and stakeholder theory, the critiques on conventional compensation structure, the need for ESG-based compensation, and the previous literature on pay for sustainability. Section 3 discusses the previous literature on P4S and comparing the advantages and disadvantages of each method while considering the individual and local differences. Section 4 describes the research approach and Section 5 outlines the proposed framework — P4S — and its four methods: ex-ante, ex-post, agency, and relative performance. The conclusion and the limitation of the study are explained in Section 6.

2. LITERATURE REVIEW

2.1. Sustainability, ESG, and stakeholder theory

Thirty years ago, social responsibility and sustainability were presumed to be the “cost of making money” (Li, 2004). This, however, is no longer the case, especially after the COVID-19 recession. The key takeaway from the pandemic is that sustainability is not a topic of “comply or explain” (EY, 2020). It is an issue that all businesses and people around the globe have to comply with. Today, we should understand that what’s good for people and sustainable for the planet is also what’s good for risk management and sustainable for long-term shareholder return. It has been found that, in the USA, which follows the market-based and Anglo-American school of thought, 83 percent of executives and investment professionals believe that ESG policies will be implemented within five years, and that “socially responsible firms can maximize shareholder welfare by engaging ESG activities” (Albuquerque, Koskinen, Yang, & Zhang, 2020, p. 1; McKinsey & Company, 2020). This result looks promising for a sustainable business and economy in Anglo-American culture.

In the post-COVID world, it is the right time to adopt a holistic perspective and involve stakeholders’ interests in decision-making in order to prevent a similar crisis in the future. We should all find a way to make smart money on all manner of socially responsible ways of doing business (Stern, 2020a, 2020b). We should also start questioning the existing executive compensation frameworks, replacing them with fairer, resilient, and sustainable executive compensation framework for stakeholders, instead of cutting or waiving compensation as a short-term solution.

Stakeholder theory ("stakeholderism") is a relationship-based model, as exists in Germany and Japan, and emphasizes the interest of a broader group of stakeholders, such as government regulatory agencies, environmental pressure groups, and general public. This broader group of stakeholders include managers and employees (internal stakeholders) as well as shareholders, suppliers, customers, local communities, government regulatory agencies, environmental pressure groups, and the general public (external stakeholders) (Schaltegger & Burritt, 2017). Stakeholder theory posits that firms do not create long-term value and do not succeed financially if they focus merely on the shareholders or owners and neglect the needs of other stakeholders. The expectations of all these parties are like the legs of a chair and if one of the legs is out of balance, the chair will collapse (Santos, 2010). Stakeholder theory, grounded in ethics and sustainability concepts, purports that environmental and social issues should be explicitly considered by companies, in addition to their financial performance. The recognition of a broader set of stakeholders will lead to improved organizational performance, the enhancement of shareholder value, improved products, better relationships, higher customer and employee satisfaction and loyalty, and enhanced reputation (Ferracane, 2010; Hansen & Schaltegger, 2014).

Stakeholder theory and sustainability have three pillars: economic (financial profit), environmental (planet safety), and social (people safety), which re-formulate the concept of financial profit to a sustainable profit (Eklund, 2019).

As stated by Stern (2020a), the concept of sustainability includes various applications, but our P4S framework is an application of ESG metrics because ESG is the broadest and most universally
applied by rating agencies and companies (Stern, 2020a, 2020b). In line with Stern (2020a, 2020b) the world’s top 120 CEOs in the 2020 Davos Manifesto of the World Economic Forum (WEF) mentioned the ESG measures as a holistic tool to achieve environmental, social, and good corporate governance objectives (Harvey et al., 2020).

Some scholars and practitioners have already grasped the significance of ESG factors. Matt Christensen, a global head of AXA Investment in Paris, mentioned that ESG factors are important for resilience, sustainability, and fairness (Bradford, 2020). The world has undergone an unparalleled health crisis and severe social fragility due to the advent of COVID-19. It has also inflicted damage on the global economy. Scholars (Albuquerque et al., 2020; Folger-Laronde, Pashang, Forr, & Elfify, 2020; Varde & Saluja, 2020) have analyzed the impact of COVID-19 on a stock value in the American, Canadian, and Indian stock markets. They found that, although the firms’ higher sustainability performance did not entirely protect them from financial losses during a severe market downturn, such as the accompanied COVID-19, most of the ESG-integrated firms still performed better than non-ESG integrated firms. Especially, in the USA, the firms with higher ESG ratings had significantly higher returns, lower return volatility, and higher operating profit margins during the first quarter of 2020 (Albuquerque et al., 2020).

2.2. The critiques on the conventional compensation structure and the need for ESG-based compensation

After the notorious corporate scandals in the USA, i.e., Enron, WorldCom, Arthur Andersen, Tyco International, and Adelphia, etc., and the 7 trillion USD of social cost to the general public (Berrone & Gomez-Mejia, 2008), exorbitant executive pay, the pay discrepancy between employees and CEOs, the misalignment between firm performance and executive pay, and the conventional remuneration plan (P4P) have all been heavily criticized by both society and researchers. For example, Jimenez-Andrade and Fogarty (2019) found that, in the USA, the equity compensation of CEOs increased almost by 17.7 percent regardless of the severity of reputational incidents. Corporate scandals and economic repercussions have led scholars to question the efficacy, fairness, sustainability, and resilience of the conventional compensation structure (Berrone & Gomez-Mejia, 2008). In Europe, the situation was not so different. For instance, the CEO of the UBS bank in Switzerland was generously rewarded in 2009 and 2010 regardless of the bank’s performance in the market and was paid 229 times more than the lowest-paid employee despite the reported loss of over 18 billion Swiss francs (19.5 billion USD) (Eklund, 2019; Hays, 2011; Stern, 2014). These lavish compensation schemes during a period of economic austerity and the decoupled link between pay and financial performance are evidence of the weaknesses of the P4P.

The traditional compensation system, derived from shareholder theory, fails to address internal and external fairness and sustainability. Hence, Hilb (2016) suggests that compensation systems should be driven by stakeholder theory and the variable portion of executive compensation should be incorporated with both financial and non-financial performances. Moreover, prior research has also criticized the conventional executive compensation framework by calling it pay-without-performance, populist, unfairness-based, sticky pay, and undermining incentives for investment and innovation (Bebcuk & Fried, 2004; Ederer & Manso, 2013; Kim, Yang, & Lee, 2017). Hermann Stern, Chairman of Obermatt AG, agrees that an ethical, fair, sustainable, resilient compensation system should include everyone who may be affected by a company’s action in decision-making (Eklund, 2019). Dr. Stern also stated that “performance-linked-pay may cause severe and undesired side effects, such as high pay, public outrage, pay gap discrepancies, earning manipulation, etc.” (Eklund, 2019, p. 130).

Various stakeholder groups, including investors and the general public, have asked for the inclusion of the non-financial components of corporate performance in CEO compensation contracts (Deegan & Islam, 2012; Ferracane, 2010; Hilb, 2016). For instance, despite the conflicting messages about sustainability and climate change from American government leaders, shareholders and investors worry about environmental and social issues and believe that it is time to tie executive compensation to sustainability in order to increase corporate awareness and accountability for ESG factors (Burchman & Sullivan, 2017). Exxon Mobil’s largest shareholders voted in support of resolutions asking the corporation to address climate-change risks and opportunities and to reward the CEOs for the social and environmental performance (Berrone & Gomez-Mejia, 2009b). In August 2019, major American institutional investors (BlackRock and State Street) also amended voting guidelines by calling upon companies to raise attention to ESG factors, and communicate and disclose how they are incorporating ESG into governance and remuneration practices (Newbury, Delves, & Resch, 2020).

In the post-COVID-19 crisis, in particular, the overwhelming demands on the part of investors for transparent, consistent, reliable, and comparable ESG disclosures have increased due to the dire, visible, and undisputed effects of the over-exploitation of habitats, wildlife, and the environment (Bennett, 2020; Gatti, 2020; Poon & Peiris, 2020). Investors have been clear that ESG information is material to their decision-making. Thus, the SEC has been urged to develop principle-based rules for ESG disclosure (Azizuddin, 2020; Harvey et al., 2020; Lee, 2020).

Flammer, Hong, and Minor (2019), Gomez-Mejia et al. (2010), and Baraibar-Diez et al. (2019) proved that ESG-based executive compensations trigger executives to devote their energy to ESG factors, and this, in turn, increases corporate sustainability and financial performances over the long term. In simpler terms, ESG disclosure, ESG performance, and ESG-based compensation contracts are interrelated. Thus, ESG-based compensation contracts are as equally prominent as the ESG disclosure guidelines to establish socially and environmentally legitimate businesses around the globe.

As a result, this paper aims to contribute to the literature and practice by starting a debate on the adaptation of the P4S compensation frameworks and their disclosures to investors in the compensation/annual reports and by introducing...
the four methods for the ESG-based compensation schemes. This will motivate board members to include ESG performance criteria in the design of executive compensation packages and inspire scholars to conduct future research on this topic.

2.3. Previous literature on pay for sustainability (P4S)

This section sheds some light on the previous research on P4S. As a result of the literature review and discussion with practitioners, it is noted that there is a need to conceptualize a framework for ESG-based compensation schemes. Before introducing the framework in Section 5, the relevant previous literature is reviewed.

Concerning the corporate governance characteristics and ESG, Tamimi and Sebastianelli (2017) and Haque (2017) found that independent, larger, diverse, and representative boards can resolve the problem of “stakeholder mismatch” (conflicting interests between stakeholders) by making a balance between financial and non-financial goals, and by including ESG factors in the compensation contracts. In addition to board size, diversity and independence, and CEO duality, Al-Shaer and Zaman (2019) reported a positive correlation between the existence of the sustainability committee and the inclusion of sustainability-related targets in CEO compensation contracts. Silva and Feitiero (2019) emphasized that strong corporate governance mechanisms should be adapted to mitigate the conflict of interest between the agent and the principal and build a link between executive variable pay and sustainability performance. In other words, organizations that have a stakeholder-based strong corporate governance system with a large, independent, and diverse board and/or a sustainability committee generally have a sustainable executive compensation policy.

The findings of the research on the alignment between CEO compensation and corporate sustainability (ESG, CSR, or non-financial) performance are mixed. These findings can be grouped under three categories: positive, negative, and no association, or no alignment. Mahoney and Thorn (2006), Davilla and Venkatachalam (2004), Berrone and Gomez-Mejia (2009a), Baraibar-Diez et al. (2019), Callan and Thomas (2014), Emerton and Jones (2019), Hong, Li, and Minor (2015), Jouber (2019), O’Connell and O’Sullivan (2014), and Schiehall and Bellavance (2009) reported the positive impact of the ESG-based compensation contracts on the corporate sustainability performance.

Other scholars reported either a negative relationship or no alignment between the CEO’s pay and corporate sustainability performance, which indicates a lack of pay for sustainability. The negative linkage between CEO pay and ESG & CSR performance is also supported by Bekker, Benson, and Faff (2014), Miles and Miles (2013), Cai, Jo, and Pan (2011), Stanwick and Stanwick (2001), and Frye, Nelling, and Webb (2006). On the other hand, Dardour and Husser (2016), McGuire, Dow, and Arghyed (2003), Cordeiro and Sarkis (2008), and Benson and Davidson (2010) found a lack of association between CEO ESG score and corporate ESG score.

Like every method, the inclusion of ESG criteria in executive pay schemes has advantages and disadvantages. Rewarding ESG performance at the top will stimulate executives to deploy efforts and resources toward ESG initiatives, and this, in turn, will increase institutional legitimacy, corporate reputation, resilience, sustainable growth, and financial performance in the long term. Social legitimacy enables firms to take better advantage of new market opportunities and to run less risk of social and legal sanctions and penalties. Good social performers can attract better suppliers, employees, and customers. In addition to the advantages of ESG-based compensation schemes, it has some challenges or disadvantages. The first challenge is as to how to build an association among CEO compensation, corporate ESG performance (pay for ESG), and financial performance. This study aims to answer this question or challenge in Section 5. Furthermore, the second challenge is which targets should be linked to CEO compensation: selecting financial targets is easier than selecting ESG indicators. In essence, there is inadequate research in this area and demand from investors to develop ESG indicators for each sector. The third challenge is the stakeholder mismatch. In the stakeholder approach, the firm has a holistic approach and considers the needs of a broader array of constituencies. This may sometimes create a conflict of interests between the parties, such as the conflict in the benefits to the environment, employees, and stakeholders. This problem becomes severe when the stakeholders benefiting from such actions are not the same stakeholders evaluating the organization’s and the CEO’s performance. The fourth challenge is that, besides extrinsic motivation, the CEO should have intrinsic motivation to pursue sustainability, but previous economic literature has shown that extrinsic motivation (Maas & Rosendaal, 2016). Then, it becomes a real challenge of how to include the intrinsic factors in CEO compensation programs (Berrone & Gomez-Mejia, 2009b).

In summary, Maas and Rosendaal (2016) stated that these mixed findings in the current research on CSR/ESG and executive remuneration show that an adequate understanding has not yet been achieved, so more research is needed. In a similar vein, Stern (2020b) believes that the reasons for the mixed results in the ESG and CEO pay literature are the poorly designed ESG compensation schemes or ESG bonus plans and the symbolic inclusion of ESG criteria in the CEO compensation plans.

Interestingly, all the studies to date have investigated either the usage of ESG factors in the remuneration contracts or the link between ESG performance and executive compensation programs. However, they have not explicitly investigated sustainability targets in executive remuneration schemes, and they have not examined the methods of P4S or developed a framework for the ESG-based compensation plans (Flammer et al., 2019; Maas & Rosendaal, 2016; Stern, 2020a, 2020b). As a result, this paper aims to fill this gap in the literature and practice by developing the P4S framework to reach more resilient, sustainable, and fairer executive pay.

3. COVID-19: LESSONS LEARNED

COVID-19 has resulted in global crises of health, humanity, society, and the economy. COVID-19 is believed to have started in Wuhan, China, in December 2019, and rapidly spread throughout the world (Fuchs, 2020). All countries have taken
some kind of preventive measures, such as social distancing, curfews, stay-at-home orders and/or lock-downs, etc., to prevent or limit the diffusion of this viral infection and to maintain the healthcare benefits (Eklund, 2021; O’Malley, 2020). At the end of May 2020, the economies in the USA and Europe were re-opened to a “new working normal”.

COVID-19 has had the biggest impact on mankind since the Second World War and the Spanish flu that followed the First World War. It as also inflicted huge and far-reaching economic damage (Arora & Mishra, 2020). COVID-19 is very different from previous epidemic diseases, e.g., SARS, H1N1 (Swine Flu), etc., and other financial crises. Hassan, Hollander, van Lent, Schweder, and Tahoun (2020) empirically proved that the global economic impact of COVID-19 was the worst, most devastating, and most brutal, compared to previous epidemics and financial crises. For instance, in the USA, 45.7 million have filed for unemployment subsidy during the pandemic as of June 13, 2020, which is more than the figure in the 1930s Great Depression and is greater than the combined populations of the US states (Lanccik, 2020). In the UK, the unemployment rate rose to 10% (Rushe, 2020). Every country in the world has been negatively affected by COVID-19. It is both a pandemic and a global financial crisis. According to the World Trade Organization’s early estimates, “major economies will lose around 2.4 to 3.0 percent of their gross domestic product during 2020 due to COVID-19” (Verma & Gustafsson, 2020, p. 253).

The pandemic is also a sign of non-sustainable economic globalization. COVID-19 has demonstrated that societies and businesses should prioritize sustainable economic systems and social objectives (Van Barneveld et al., 2020). As stated by Al Gore, the former vice-president of the USA, the pandemic provides politicians with an opportunity to build a resilient, healthy, fair, zero-carbon circular economy, and provides corporate leaders with a chance to put ESG factors at the very heart of their decision-making. Similarly, the British Academy and British Roundtable have urged businesses to take a holistic approach by leaving the narrow shareholder approach and taking a multi-stakeholder approach, instead (Gore & Blood, 2020).

COVID-19 might be a portal to a greener, ecological, sustainable, and collective economy (Van Barneveld et al., 2020), which will help to build a harmonious society, have a holistic stakeholder approach, and remove pay inequalities or, at least, narrow the pay gap. The key takeaways from the COVID-19 crisis for businesses and board of directors can be listed as follows: the importance of the welfare of the employees as human capital, digitalization, cybersecurity, sustainable corporate governance, ESG-based executive compensation, the pay-fair pay gap between the CEO and the employees, pay equality, sustainable supply chain, board composition, and board diversity, the long-term perspective, succession planning, and flat organizations (Eklund, 2021; Schmitt, Probst, & Tushman, 2020; Verma & Gustafsson, 2020). For instance, Winarsih, Indriastuti, and Fuad (2021) discussed that companies, regardless of their size, should be somehow a part of the digital ecosystem and be sustainable businesses. Mori et al. (2020) believe that “healthy people and sustainable businesses are conducive to the healthy and sustainable planet” and suggests creating resilient and sustainable businesses and society in the long term while addressing the urgent concerns in the short term (i.e., short-term emergencies with a long-term perspective). Verma and Gustafsson (2020) are the other scholars who highlighted the significance of the long-term perspective and forward-thinking, in addition to advanced technologies, supply chain resilience, and sustainability, and organizational agility. On the other hand, Delves et al. (2020) and O’Kelley and Goodman (2020) argued about expanding human capital management (HCM) or human capital governance (HCG) responsibilities for compensation committees, and they affirmed that the compensation committee should re-frame the CEO compensation scheme by considering HCG factors. HCG is the subset of ESG or a big part of the “S” of the ESG measure. HCG or HCM includes four factors: pay fairness and employee well-being; inclusion and diversity; a talent for the future; and corporate culture. Pay fairness addresses male and female pay gaps for similar positions and the CEO-employee compensation and other executives’ and employees’ salaries. As of 2019, only 44 percent of S&P 500 companies include HCG measurements in their annual incentive plans of the CEOs (Delves et al., 2020). Moreover, Gau, Delves, and Resch (2020) stated that, during the COVID-19 crisis, executive compensation should also be linked to management actions that mitigate the spread of the pandemic, such as working from home, social distancing, health protocols, etc., ensure employees well-being, and develop workforce resilience. They emphasized that it is the just-right time to accelerate the adoption of ESG metrics with a greater focus on HCG if companies still have not done so to date.

Not all companies have been affected by the COVID-19 recession in the same way. Some companies are struggling, but others are thriving. There are both winners and losers in the COVID-19 crisis. Oil and gas, travel, transportation, restaurants, airlines, hotels, entertainment, automobiles, real estate, construction, sports, and retail sectors were losers in the outbreak. Grocery stores, cleaning products, pharmaceuticals, health care, cybersecurity, e-commerce, technology, and communication industries were the winners. For instance, Zoom video’s year-to-date gain increased approximately by 130 percent, but Ryanair’s full-year profit went down 29 percent (Eklund, 2021; NACD, 2020; Podstupka, 2020). Another example comes from famous American companies, such as Sears, JCPenney, Neiman Marcus, and J. Crew, and they are all under enormous financial pressure (Donthu & Gustafsson, 2020). As a result, the impacted sectors have either waived or reduced their CEO compensation. Take the examples of Ryanair and Heathrow Airport: Ryanair cut its CEO’s total compensation by 50 percent and Heathrow Airport has waived its CEO’s salary for 3 months (Patterson, 2020). As a result, from the fair, resilient, and sustainable executive compensation and corporate governance point of view, the conventional approach of paying the CEOs for their financial performance (P4P) — does not work fairly in this given scenario. Should we praise the CEOs in the thriving sectors and punish those in the failing
sectors based upon the P4P approach (reward for good luck and punish for bad luck)? How fair, resilient, and sustainable is it for businesses and society? It indicates that it is the right time for a change in compensation schemes.

On the other hand, Willis Towers Watson’s survey in June 2020 revealed that the majority of American companies (74%) have decided to proceed with their CEO compensation framework, which is consistent with last year’s because they are not sure how to tackle this complex and controversial topic. Only 12 percent have indicated that they will make substantive changes in their executive compensation schemes (Marshall, Mordente, & Boyce, 2020). Hence, this paper guides these hesitant practitioners on how to stay resilient and reshape the compensation scheme with a sustainable corporate governance perspective. It also contributes to the literature by advancing the knowledge in the field and developing a reliable and scientific framework (P4S) based upon stakeholder theory.

4. RESEARCH APPROACH

The research approach of this conceptual paper is theory adaptation. Jaakkola (2020) stated that “Theory adaptation papers develop contribution by revising extant knowledge — that is, by introducing alternative frames of reference to propose a novel perspective on an extant conceptualization (MacInnis, 2011)” (p. 23). In simpler terms, this study generates novel insights on a fair, sustainable, and resilient ESG-based compensation framework by adapting the existing theory and contributes revised or new knowledge toward extant knowledge. This article can be also considered as a commentary because it offers a focused argument on a specific issue by delivering the insights of the compensation consultants. In other words, it provides readers with novel and fresh perspectives on ESG-based compensation issues.

This P4S framework is reliable because it has been scientifically developed based upon previous research, stakeholder theory, the sustainable corporate governance concept, and practitioners’ insights. In line with Jaakkola (2020), Cho and Fiore (2015), the framework has been designed by following these phases:

- Phase 1 — the concepts, theory, and previous literature are investigated.
- Phase 2 regards the practical insight. Each method of the framework has been discussed with the five consultants specialized in executive compensation and indexing company performance. These consultants (four advisors and a CEO) are working at one of the top-tier compensation consulting firms in Zurich. Four compensation advisors are working under the direct supervision of the CEO. The CEO of this consulting firm holds a Ph.D. in corporate governance and executive compensation and advises various clients on ESG-based compensation schemes. His insights were gained while he was advising and reviewing the compensation schemes of the various reputable companies in Switzerland with his team of four advisors. The CEO's insights have dominated our theoretically driven framework since he is one of the most experienced practitioners in this consulting firm. His valuable insights made the framework applicable to real-life, simple, practical, and holistic without waiving, capping, limiting, or strictly regulating executive compensation. Switzerland is unique from the perspective of executive compensation: it is the highest executive compensation paying country in Europe, and it has a direct-democracy structure, such as a consensus-based culture and a referendum on CEO pay (Rost & Weibel, 2013; Sharma, 2019).
- Phase 3 — based upon the review of the theory and literature, and the insights collected, the final four methods of the framework are conceptualized and analyzed for their advantages and disadvantages, which are presented in Section 5.

One of the strengths of this approach is that a theoretically driven framework has been developed from practitioners’ insights. That is, it provides both practitioner and academic approaches to sustainable compensation schemes. This research approach may have some limitations and they are discussed in Section 6. These limitations attempt to highlight future research avenues and inspire scholars to conduct comparative studies.

5. PROPOSED FRAMEWORK: PAY FOR SUSTAINABILITY

The COVID-19 recession has revealed that the traditional concept of P4P is not resilient, fair, or sustainable. As illustrated in Figure 1, P4P depends on the tenets of shareholder theory and shareholder value maximization. As a result, only the financial indicators, such as total shareholder return, earning measures, and return measures, etc., are taken into consideration to measure the success of the firm and the CEO's performance. As already noted, in unprecedented times, e.g., the COVID-19 crisis, P4P fails because it results in either rewarding the CEO for good luck or punishing the CEO for bad luck.

Figure 1. Pay for performance framework: Shareholder approach

![Figure 1](Image)

 Owners

Investors

Total shareholder return (TSR)

Other return measures (ROI, ROA, ROE)

Capital & investment

CEO pay ($) 

Risk capital measures

Stockholder

Shareholders

Earning measures (EPS, EBIT, EBTIDA)

Economic profit (EVA)

Source: Authors’ elaboration.

On the other hand, P4S is an inclusive, sustainable, fair, and resilient compensation structure. P4S is also called ESG (based) executive compensation which depends on stakeholder theory. As seen in Figure 2, stakeholder theory requires
the involvement of the interests of all the stakeholders in decision-making about executive compensation, so the ESG-based compensation schemes involve not only shareholders’, investors’, and executives’ interests, but also consider the interests of the employees, general society, the environment, creditors, suppliers, unions, and the government. The sustainability-related targets, especially E-S-G, have three pillars: economic (financial profit), environmental (planet safety), and social (safety of people). As a result, it is a fairer, sustainable, inclusive, and resilient approach.

**Figure 2. Pay for sustainability framework: Stakeholder approach**

![Figure 2](image)

*Source: Authors’ elaboration.*

The ESG performance is used to gauge the sustainability level of the company. A higher score means the better sustainability performance of the firm. ESG performance can be measured either by the company’s self-determined or relative sustainability goals or by independent rating agencies, such as Refinitiv — Thomson Reuters ESG Research Data, MSCI ESG Research, ISS ESG, S&P Trucost, and RobecoSam, RepRisk, Sustainalytics Company ESG Reports, the Bloomberg ESG Data Service, Corporate Knights Global 100, State Street Global Advisor (SSGA) R-Factor, EcoVadis, and Vigeo Eiris, etc. (Harvey et al., 2020; Stern, 2020a, 2020b). Even though different agencies have different components in their ESG measures, in general, “E” stands for environment, e.g., natural environmental resource use, the health of the biosphere, emissions, and innovation, “S” stands for social, such as the workforce, human rights, the community, and product responsibility, and “G” stands for governance, e.g., the levels of development, awareness, and control of the organization, management, corporate governance, and the shareholders (Benn, 2012; Eikon, 2018; Eklund, 2019).

The framework is kept simple in order to apply it successfully to real-life, and it is made up of four methods: ex-ante, ex-post, agency, and relative performance (Figure 3). To clarify, in the following methods, the variable compensation indicates long-term incentives. The non-financial performances, such as ESG scores, are relevant to the long-term performance and strategies of the organizations. Thus, this misalignment between ESG scores and short-term executive pay should be resolved and it should be aligned with the long-term incentives (Eklund, 2019; HCM, 2018).

**Figure 3. Methods of pay for sustainability framework**

![Figure 3](image)

*Source: Authors’ proposal.*
The ex-ante method: This is the most common method used in sustainable organizations. In this method, as illustrated in Figure 4, the ESG targets are forecasted ex-ante and the level of variable compensation that will be paid to the executives is linked to the degree to which these ex-ante (pre-defined) ESG targets are met.

Figure 4. The illustration of the ex-ante method

1. Step — Set and forecast: Set the ESG targets and include them in the CEO compensation contracts

2. Step — Evaluate and decide: Evaluate the performance of the CEO based on ex-ante ESG targets:

   The degree to which ex-ante ESG targets met

   The level of variable CEO compensation paid

The advantages of the ex-ante method are as follows: it is relatively straightforward, and targets are set and controlled internally. The ex-ante goals provide CEOs with clear instructions and the motivation to reach the targets. On the other hand, this method may suffer from managerial entrenchment. For instance, if the firm does not have a strong corporate governance system, the CEO may have gained the power to maintain his or her own self-interest, instead of that of the stakeholders. When CEO duality exists, then the CEO has the power and the influence in the negotiations of the ex-ante goals with the board of directors. In this case, the goals may not be realistic, honest, holistic, or challenging enough. Another disadvantage of this method is that it focuses merely on the extrinsic or pecuniary rewards and ignores the intrinsic rewards, and thus it destroys the intrinsic motivation of CEOs, such as altruism, fairness, and self-image, etc. Moreover, this method is not sufficiently nimble and flexible to changes due to the pre-set targets. In simpler terms, it may be a more reasonable method for organizations that have stable performance and a strong corporate governance structure.

The ex-post method: The ex-post method is standing just on the opposite side of the ex-ante method on the P4S framework (Figure 5). As delineated in Figure 5, the steps of the ex-post method are reversed, compared to the steps of the ex-ante method. It means that the ESG targets are defined as ex-post to back up or justify the compensation committee’s or the BoD’s decision on the level of executive remuneration. This method can also be called as “after the fact evaluation”.

Figure 5. The illustration of the ex-post method

1. Step — Evaluate and decide: Evaluate the CEO’s performance and define the level of the compensation contracts

2. Step — Justify: Back this decision up with the ex-post ESG targets

The advantages of this method are that it is highly motivating, internally controlled, flexible, and challenging. For instance, Chi, Liu, Qian, and Ye (2019) conducted behavioral experimental research and found that after the fact (ex-post) performance evaluations motivate executives more than before the fact (ex-ante) performance evaluations. This method has proved superior during the period of crisis because the targets are set or revised after the fact. For example, if the economy is doing well, the BoDs set tougher targets. If there is a recession, they have lenient targets. In this method, the targets are set after the facts, so it will prevent the firms from awarding the CEO for lowering greenhouse emissions during COVID-19 and the curfew because it was not the real success of the CEO. It has also some disadvantages. The disadvantages are that it requires a high level of trust between the principals and the agent, and the agent’s acceptance that the principals make the best judgment at their discretion. This method also compels the organizations to have competent principals who evaluate the “after the fact” performance and set the ESG targets credibly and transparently. As a result, shareholders may be skeptical about this method and its performance appraisals if there are no competent members on the board and compensation committees. Thus, this method may be preferred by organizations with a strong corporate governance structure and a high level of trust between the CEO and BoDs, and between shareholders and BoDs. It is also the right method if there are unstable economic conditions or a recession in the market or the country.

The agency method: The use of independent ESG rating agencies is the third option for the P4S system. As depicted in Figure 6, first the rating agency is selected and included in the compensation contract. When the evaluation period comes, the agency’s ESG rating for the company is compared to the ratings of the benchmark (peer group) to determine whether the CEO has under-performed or over-performed. The relative ESG performance of the company defines the level of the CEO’s variable compensation.
At the beginning of this section, we named the major market players providing the ESG scores of listed companies around the globe. Each rating agency has its own methodology and components in its ESG measure. Because of competitive industrial and trade secrets, rating agencies do not reveal the details of their ESG rating methodology to the public, which makes it a less transparent method out of the four P4S methods. This non-transparency in rating agencies' methodology is a major limitation to the use of ESG ratings to measure ESG performance in executive incentive compensation schemes. These agencies are independent, and their ratings are credible because their services are not paid for by the companies. There might, however, have been some exceptions during the global financial crisis, i.e., 2007–2010. ESG ratings are primarily made for socially responsible investors who want to achieve a good return on their investment while respecting society and the environment. Therefore, the primary focus of rating agencies is on the undiscovered facts when they are calculating the ESG scores. In other words, ESG ratings serve investors in order to answer the question of “where the interesting investment opportunity is based upon the hidden ESG strengths, weaknesses, opportunities, and threats”, so it does not measure the good or bad past ESG performance of the company (HCM, 2020; Stern, 2020a, 2020b). Another disadvantage of the agency method is that it is static in terms of the measurement approach and time. In other words, it is not flexible and variable, so without variability in the performance indicators, there is no variability in executive compensation. As a result, the use of ESG ratings in the executive variable compensation is limited or not so common in practice.

However, the agency method also has advantages. The first advantage, as mentioned above, is that agencies' ESG ratings are accepted as independent and credible scores because they are measured by independent and reputable rating agencies, such as Refinitiv — Thomson Reuters ESG Research Data, ISS ESG, S&P Trucost and RobecoSam, the Bloomberg ESG Data Service, etc. The second advantage is that managerial entrenchment, internal politics, and internal target negotiations between the principals and the agent in order to determine the ESG indicators are not a cause for concern.

To sum up, this method may be useful for the companies in need of externally controlled, credible, and independent ESG ratings owing to their weaker corporate governance structure and/or a high level of management power (managerial entrenchment). Moreover, it may be one of the good methods to utilize during periods of crisis since ESG agency ratings compare a rated company’s ESG performance to what similar companies have managed to achieve under similar conditions. In a sense, it is a tool of relative performance measurement, so it neutralizes the external factors in the economy or the sector. Executives are not rewarded or punished for the factors out of their hands or beyond their control.

**The relative (indexed) performance method:** As suggested by Huber et al. (2020), to cope with the pandemic hurdle from the perspective of CEO compensation, companies should move to relative measures or relative performance evaluation (RPE). RPE is defined as a tool to compensate CEOs based upon their performance relative to the performance of a peer group, which may lessen the risk of penalizing or rewarding the executives for the factors out of their control, such as the impact of COVID-19 (Aggarwal & Samwick, 1999; Bertrand & Mullainathan, 2001; Gong, Li, & Shin, 2011). The main difference between the relative (indexed) performance method and the agency method is that the relative performance method is transparent and partially internally controlled because the indicators in the metrics are determined by the company, and each indicator in the metrics is relevant to the company’s and the CEO’s performance evaluations. In other words, the ESG score computed according to the relative (indexed) performance method is specific to the purpose and the company, so the evaluation and judgment on the level of variable executive compensation are more reliable.

As shown in Figure 7, the first step in this method is to determine the ESG specific indicators that will be part of the relative performance measurement, which is called the metrics. Then, the second step is indexing. It is called indexed because the internal performance of the company is compared to the performance of benchmarked companies (Stern, 2011). In simpler terms, the second step is the selection of the peers to be indexed, and the collection of the data for the peers. The final step is the evaluation of the CEO’s relative performance to determine whether the CEO has under-performed or over-performed. The relative ESG performance of the company defines the level of the CEO’s variable compensation.
Besides the advantages of transparency and being partially internally controlled, it is flexible in the face of change and its indexing approach neutralizes the distortions from unprecedented events, economic cycles, and other external factors in performance measurement, so it makes executive compensation contracts fairer, resilient, and sustainable over the long term. It is also challenging because only the outperformance is rewarded. Moreover, intrinsic motivation remains intact. Mistrust and the conflict of interests between the principal and the agent are eliminated because this method alleviates the political and costly internal target negotiation problem. There is no absolute target to negotiate and the CEO is either an under-performer or an over-performer, compared to his or her peers. On the other hand, the weaknesses of this method are the need for the data collection on peers, and the potential debate over some peers and metrics. Monitoring peers and collecting data on them could be costly and the company may need to share some information with the peers in order to collect the relevant performance indicators in the metrics from the peers. Thus, this method is also called a “partially internally controlled and partially externally controlled” method. To conclude, the benefits of the method far outweigh its disadvantages.

6. CONCLUSION

This paper first provided the readers with the theoretical background and the gaps in the literature, which enlightens scholars to possible future research avenues. Then, it illuminated the lessons learned from COVID-19, and its impact on our economy, businesses, and compensation systems. Finally, it proposed a reliable, sustainable, resilient, and scientific ESG-based CEO compensation framework by outlining four methods.

As noted in the previous section, each method of the framework has advantages and disadvantages and each method fits different scenarios or companies. However, it can be concluded that the last method — the relative (indexed) performance measure — has more benefits than its costs, neutralizes the factors that are not under the direct control of the CEO, maintains the intrinsic rewards in the CEO compensation contracts, and is flexible and adaptable to the unexpected changes in the technology, market, economy, and the globe. One of the compensation consultants in the executive compensation consulting company in Switzerland also mentioned that negotiated targets are more common and trusted in practice than the comparison to peers. It means that there is still a way of improvement in the compensation schemes and the methods of evaluating the CEO’s performance in practice. This study may help the practitioner to overcome the resistance to the relative performance measurement and ESG ratings.

To sum up, there is no one-size-fits-all solution because companies have different profiles, corporate cultures, and corporate governance structures, so neither the authors nor the publisher gives any warranty on any specific method. However, this paper advances the knowledge in the field by proposing a reliable and scientific framework with four distinct methods and helps companies find their own best way while investing in the P4S framework and addressing environmental, social, and governance matters.

The limitations of the study are that it does not provide any empirical or generalizable results on the superiority or inferiority of the compensation methods, and the practical insights are collected from the consultants of a single executive compensation consulting firm in Switzerland. However, scholars can collect more insights from the different remuneration consulting firms in Switzerland, Europe, and the USA for future comparative studies, and can conduct quantitative research via surveys.

Every model or method has caveats, both in theory and in practice. This method may be considered simple or not complex. Why should complex methods be used if simple methods solve the problem? We need a simple, practical, and holistic tool without waiving, capping, limiting, and strictly regulating executives’ compensation because the main issue in practice is the complexity of the existing compensation schemes and frameworks (Eklund, 2019; Hilb, 2016). As a result, this framework serves its purpose and may prove to be adaptable and useful in future crises.

Figure 7. The illustration of the relative (indexed) performance method

1. Step — Prepare metrics: Determine the ESG specific indicators in the relative performance measure and include them in the CEO compensation contracts

2. Step — Indexing: Select the peers and collect their data

3. Step — Compare, evaluate, and decide: Compare the relative ESG score of the company with the ESG score of a peer group/benchmark:

| Under-performed or over-performed compared to peers’ ESG score? | The level of variable CEO compensation paid |

Step 2: Compare, evaluate, and decide: Compare the relative ESG score of the company with the ESG score of a peer group/benchmark:

Step 3: Prepare metrics: Determine the ESG specific indicators in the relative performance measure and include them in the CEO compensation contracts

Step 4: Indexing: Select the peers and collect their data

Step 5: Compare, evaluate, and decide: Compare the relative ESG score of the company with the ESG score of a peer group/benchmark.

Step 6: Repeat steps 2 to 5 until a satisfactory result is achieved.
REFERENCES


