Are retrospective adjustments to sustainability reports helping CEOs score a bonus?

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A lack of clarity around sustainability reporting is allowing ASX-listed companies to retrospectively alter figures, ensuring CEO bonus pay tied to these metrics is realized, new research suggests.

Sustainability reports serve as critical tools for investors, regulators and other stakeholders to gauge a company's environmental, social, and governance (ESG) performance. They highlight issues such as environmental pollution and worker safety that might otherwise be overlooked.

Close to 90% of ASX top 200 companies provide detailed ESG information. Many of these companies link a percentage of CEO bonus pay with ESG performance, to incentivize executives to focus on social and environmental impacts as well as financial outcomes.

Typically, around 17% of bonus pay is allocated to sustainability targets, which means that on average, CEOs will increase their cash bonus by around $200,000 by meeting these targets. However, new analysis suggests this incentive may be encouraging manipulation rather than real action.

The study, titled "CSR Restatements: Mischief or Mistake? " by Associate Professor of Accounting Helen Spiropoulos from the University of Technology Sydney and Dr. Rebecca Bachmann from Macquarie University was published in the *Journal of Management Accounting Research*.

The researchers examined 674 Corporate Social Responsibility (CSR) reports, as well as compensation and other data publicly available in 1567 annual reports, from a range of top 500 ASX-listed companies between 2004 and 2020.

They found that CEO compensation contracts that link bonus pay with CSR performance measures were associated with a greater number of "restatements," or retrospective changes to reported CSR figures, particularly around social measures such as gender targets or safety. In fact, 33.5% of all restatements were of one or more CSR measures that were tied to CEO bonus.

"Currently, there is significant discretion in how ESG performance is measured and reported, and one way to show improved performance in the current year, is to adjust, or restate, last year's score to reflect worse performance relative to this year," said Associate Professor Spiropoulos.

"If restatements were due to improvements in measurement, there should be no bias in the direction of restatements—they could make performance look better or worse. However, we found a significant bias towards making last year's performance look worse relative to the current period."

The study found that only 15% of revisions were reported to be due to error, whereas 69% were reported as due to changes in measurement. The magnitude of the change was also significant at around 28% of the original value and even larger (36%) when the revision was of a metric included in the CEO's bonus.

Restatements to reported sustainability figures were also more likely to occur when a larger weighting was given to sustainability targets in the CEO's compensation contract.

In June this year, the International Sustainability Standards Board (ISSB) released its inaugural set of ESG standards, slated to take effect from January 2024. These standards aim to provide a single global baseline of sustainability-related disclosures.

The researchers argue the ISSB and the Australian Accounting Standards board (AASB) must address measures and metrics in subsequent revisions of sustainability standards to limit the potential for manipulation.

Approximately 22% of firms have their CSR performance audited, primarily by one of the big four audit firms.

"Currently, there is significant discretion in how ESG performance is measured. Auditors who will be required to audit environmental performance disclosures under forthcoming sustainability assurance standards should also investigate the legitimacy of restatements," said Dr. Bachmann.

The results of this study also carry implications for compensation committees and regulators considering the integration of CSR-related performance measures into executive compensation contracts.

"The irony is striking—what was intended to be a mechanism to drive positive environmental and social change may instead act as an incentive to manipulate sustainability performance."

More information: Rebecca L. Bachmann et al, CSR Restatements: Mischief or Mistake?, *Journal of Management Accounting Research* (2023). DOI: 10.2308/JMAR-2022-028

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