AUSTRALIAN CEO COMPENSATIONS: ARE THEY REWARDED FOR BEING GREEN?

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ABSTRACT

The environment is a major concern for stakeholders and pressure is growing on organizations to behave as responsible corporate citizens. The issue is whether companies understand this and are improving their environmental performance. This, in turn, raises the question as to how senior management, specifically chief executive officers (CEOs), are encouraged to focus on the "green" aspects of their business. In this study, we examine the relationship between CEO compensation and the financial and environmental performance of Australian companies. The results of the study show a positive relationship between CEO remuneration and financial performance, but no conclusive relationship with environmental performance was found.

BACKGROUND

Due to changes in community awareness and community action, companies are focusing more on social and environmental issues rather than just the traditional financial aspects of their business. This may be either a proactive response (avoid regulatory interference), a reactive response (pressure from coordinated campaigns), a risk-based response (reduce socio-environmental contingent liabilities), a financial response (improved returns to "green" businesses) or a combination thereof. Regardless of the reasons focus of business has shifted to now include the social and environmental [1] [2] [3] [4] [5] [6].

Given the new "green" tinge to business bottom-lines, the question arises as to how senior management, specifically CEOs, are encouraged to focus on these aspects of their business. Historically, CEOs have been encouraged to improve the returns to shareholders by the inducement of shares and stock options as part of their remuneration packages. Using a similar agency theory-based approach, this paper will investigate whether there is a linkage between environmental performance and CEO remuneration. It has been assumed that shares and stock options are provided only as an incentive to improve financial performance, and that any environmentally aligned remuneration would be reflected only in the salary component of the CEO's package. The hypotheses being tested are therefore:

H1: CEO compensation is positively related to company financial performance; and
H2: CEO compensation is positively related to company environmental performance.

In assessing these hypotheses, the 2002 Good Reputation Index (the Index) [7] will be utilised to provide the measures of financial and environmental performance. The Index is published annually by two of Australia's major daily newspapers - *The Age* in Melbourne and the *Sydney Morning Herald* in Sydney. The Index ranks the top 100 companies listed on the Australian Stock Exchange against a range of criteria, including financial, environmental and social performance.

The Index uses 22 groups representing community stakeholders, regulators and expert organisations to score and then ranks these companies across a range of areas: employee management, environmental performance, social impact, ethics and corporate governance, financial performance, management and market focus, and a final overall ranking. This paper will focus on two of these areas, being financial performance and environmental performance.

For each assessment category, a subset of the 22 groups with specific interest and expertise in the category area scores each company against their own nominated performance criteria, after which rankings are determined by each stakeholder and then aggregated into a final overall ranking for that category. Environmental performance was assessed by the Victorian Environment Protection Authority, The Wilderness Society, Greenpeace Australia, the Australian Conservation Foundation and the Monash Centre for Environmental Management. Financial performance was assessed by the Australian Shareholders' Association, the Institute of Chartered Accountants and the Securities Institute of Australia.

ANALYSIS AND FINDINGS

For each of the categories considered — environmental performance and financial performance — the individual assessors' scores were totaled to provide an aggregated score for each company. This was done as the Index only provided an aggregated ordinal ranking and this was not suitable for the present analysis. In the environmental performance category, the Greenpeace ratings were excluded as this stakeholder only provided a ranking rather than scoring the performance criteria.

From these aggregated scores, those companies that ranked in the top 50 in either category were then carried forward in the analysis. This produced a subset of 75 companies for further study. From this subset, details on CEO or Managing Director remuneration or emoluments was hand collected using the listed entity's published financial statements from the Connect4 Database [8] for the financial year ended June 2002. The key documents referenced for this data were the Corporate Governance Statements, the Directors' Reports, the Directors' Profile and, in some cases, the Remuneration Report. As not all the companies in the sample were published on the Connect4 Database the final number of useable company data was reduced to 44 entries.

A regression analysis was then undertaken to assess the relationship between the two independent variables (the scores received for financial and environmental performance) and the remuneration paid to the CEO or Managing Director of the company. The analysis found CEO compensation to be strongly positively correlated with financial performance (Pearson $R = 0.356$) and negatively correlated with environmental performance (Pearson $R = -0.098$).

The anecdotal evidence that shareholders believe that the highly remunerated CEOs will produce superior corporate performance appears to be supported by the analysis, and that hypothesis H1 is confirmed. This is in agreement with earlier studies that found a positive link between company performance and CEO compensation [9] [10] [11] [12].

The results for CEO salary and environmental performance are not as definitive. In general, the more highly salaried CEOs head those companies with poorer environmental performance scores. This is in line with a US study by Stanwick and Stanwick [13], although their study showed a significant negative relationship between CEO salary and environmental reputation. This contradicts hypothesis H2. There are two possible conclusions that could be reached from this. Firstly, the weak relationship reported could support the view that CEOs are not rewarded for their good environmental performance and, as such, the data produces no valid relationships when regressed. Secondly, the use of the Good Reputation Index as a basis for the analysis and a measure of environmental reputation may be open to question. The measurement of social activities is extremely complex, even impossible, and the nearest measure may be perceived social performance [14]. As we are considering stakeholder perceptions of the company's environmental performance, the use of the Index would appear to be a viable measure for environmental reputation. Even so, the various parameters identified in its determination may have an impact on these results and alternative sources may be proposed to evaluate environmental performance.

CONCLUSION

This paper is an exploratory study to determine the relationship if any between the level of CEO remuneration and the company's financial and environmental performance. To this end we were unsuccessful in providing evidence of strong links between corporate environmental performance and remunerations paid to CEOs. It may be that, whilst companies are now espousing the "green" agenda, they are not yet implementing it.

Furthermore, from an investigation into the remunerations paid to CEO and the narrative disclosed in the annual reports about their performance incentives, it is apparent that environmental excellence is not yet a hurdle for CEO performance. The company's shareholders appear to maintain a focus on capital growth and they believe that these returns are purely derived from financial returns and not from a broader "triple bottom line" excellence.

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