

**ESG METRICS IN FIRM RISK ASSESSMENT: EVIDENCE FROM SHORT SELLING**

Thomas F. Lewis, Jr., Norfolk State University, Norfolk, Virginia, U.S.A.

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**ABSTRACT**

*This study investigates the value-relevance of environmental, social and governance (ESG) metrics in the formulation of investment decisions. Specifically, the extent to which investors utilize ESG metrics in executive compensation contracts to formulate risk assessment in investing decisions. Prior research regards short sellers as particularly sophisticated investors with a desire to understand a company's value creation plan by analyzing credible, standardized information to support risk assessment. However, a serious gap exists between corporates and investors over the standardization and consistency of ESG information and reporting. Prior research about the effect of executive compensation on ESG has been limited in scope and produced mixed results. These studies primarily focus on the use of ESG targets in executive compensation contracts as opposed to the effects of said targets on investment decisions. Using a hand-collected data set, the relationships between short interest, financial and ESG measures in executive compensation contracts are examined. The results show a correlation between short positions and the effectiveness of ESG target measures in executive compensation contracts indicating short sellers do incorporate the measures when assessing risk.*

**Keywords:** ESG, Executive Compensation, Short sellers, Risk Assessment, Reporting targets

**1. INTRODUCTION**

Every firm needs to maximize shareholder value. However, there is an increasing investor expectation for firms to operate in a socially accountable manner. This shift has been coined as environmental, social and governance (ESG) investing and is not only fueled by regulatory changes, but also investor activism (Goranova and Ryan, 2014; Parker, 2014). Investor activism focuses on expanding both corporate priorities and stakeholders beyond maximizing shareholder value. Prior research documents environmental impact (Lee and Lounsbury, 2011; Reid and Toffel, 2009) and corporate social performance (CSP) (David et al., 2007; Rehbein et al., 2004) as concerns for activist investors. More investors are telling firms they want information on environment, social and governance (ESG) related risks to support long-term assessments; however, a serious gap exists between firms and investors over the standardization and consistency of ESG information and reporting (PWC, 2020). ESG incentives integrated into executive compensation contracts may offer additional insight for investors looking to assess ESG-related risk.

Prior research developed on agency theory and investigating the relationship between compensation and managerial action suggests compensation contracts ought to contain metrics that deliver accretive data regarding the dimensions of managerial initiative shareholders want to advance (Ittner and Larcker, 1997). Unfortunately, the vast majority of this line of research focuses on traditional financial measures. Although recent research does seek to identify specific ESG measures, it fails to analyze the effect of the realization of said measures on investor risk perception. How do activist investors perceive risk when executives fail to realize prescribed ESG measures? This study assesses the extent to which investors utilize ESG metrics in executive compensation contracts to formulate risk assessment in investing decisions.

I anticipate this study to appeal to a broad constituency. For academics, the study adds to existing knowledge by examining how sophisticated investors reward or penalize companies for ESG efforts and disclosure through their investment process and the broader role investor activism plays in investment decisions. For the investor, this study provides another potential tool for evaluating how ESG risk management justifies firm valuation. Lastly, this research informs executive compensation consultants and boards of directors regarding the effectiveness and perception of ESG incentives incorporated in executive compensation contracts.