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WEBINAR SUMMARY REPORT

Strategic choices and ESG performance: Should managers be concerned about the [un]intended consequences of their strategy typology?

August 7, 2024

by

Dr. Olayinka Moses

Academic Programme Leader
Wellington School of Business and Government
Victoria University of Wellington

Moderator:
Prof. Neerav Nagar
Associate Professor
Finance and Accounting, IIMA

Webinar on

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About the Speaker

Dr. Olayinka (Yinka) Moses

Yinka is an Academic Programme Leader at the Wellington School of Business and Government, Victoria University of Wellington, New Zealand, and a Professor Extraordinarius at the College of Accounting Sciences, University of South Africa. He is a Fellow of Certified Practising Accountant (Australia), and member of Chartered Accountants Australia and New Zealand. Yinka is the Chair of the CPA (Australia) ESG Committee (New Zealand Division) and the current Vice President of the African Accounting and Finance Association (AAFA).

His research intersects sustainable management decisions and financial reporting, considering, among other factors, how accountability is implicated in managerial choices and corporate sustainability reporting. Yinka has been published in top-tier accounting journals such as: Accounting, Auditing & Accountability Journal; Financial Accountability & Management; Journal of Accounting Literature; Accounting and Finance; Journal of Contemporary Accounting & Economics; Pacific-Basin Finance Journal; and Meditari Accountancy Research, among others. Additionally, he holds influential editorial roles in several journals, contributing to the dissemination of knowledge and the advancement of the accounting profession. He continues to provide professional and academic leadership through insights from his research, assisting companies and professional accounting organisations in strategising their reporting practices in light of changing sustainability reporting requirements across jurisdictions, especially in developing countries.

About the Moderator

Dr. Neerav Nagar

Neerav Nagar is a Fellow of IIM Calcutta. His teaching and research interests lie in the areas of financial accounting, financial statement analysis, corporate governance and earnings manipulation. His research work has been published in leading journals like Journal of Business Finance and Accounting, Corporate Governance: An International Review, Journal of Accounting, Auditing and Finance, Journal of Business Research and Journal of Contemporary Accounting and Economics.

Abstract

As a reflection of the collective choices an organisation makes to position itself competitively, business strategy can play a crucial role in signalling a firm's mechanism for achieving environmental, social, and governance (ESG) performance. In this context, this study offers an opportunity to glean insights into how business strategy choices influence entities' ability to navigate ESG reporting and performance obligations, especially given the growing push towards mandatory sustainability reporting regimes. Adopting an ESG compliance approach embedded in the strategic strengths of a firm can indeed be a competitive differentiator. This study investigates whether business strategy influences ESG performance and, if so, which strategy typology delivers optimal outcomes. Based on data from 45 countries, the empirical evidence suggests that business strategy can significantly impact ESG performance from an overall perspective. Further analysis of the distinct components of business strategy, based on the typologies advanced by Miles and Snow (1978), reveals that Prospector firms (i.e., those that pursue a strategy of high innovation to pioneer and maintain new products in line with market trends) have a stronger positive association with ESG performance. Collectively, the study provides important insights for managers and stakeholders to understand the consequences of strategic choices on ESG performance. Practically, it offers new intuitions to aid managers in extrapolating the intended and unintended consequences of their organisation's strategic decisions, particularly in light of the increasing likelihood of jurisdictional mandates for sustainability reporting following the release of the IFRS Sustainability Disclosure Standards.

Introduction

The primary focus of this research project is to explore the strategic decisions made by companies and how these choices influence their Environmental, Social, and Governance (ESG) performance. As ESG considerations gain increasing importance in the business world, understanding the impact of these strategies becomes crucial for companies aiming to balance sustainability with financial performance.

A key aspect of this research involves investigating the strategies that managers currently employ to enhance ESG outcomes. The study seeks to answer critical questions such as: What specific strategies are managers adopting to improve ESG performance? Should their primary concern be the effectiveness of these strategies in achieving better ESG metrics, or should they be more focused on the potential long-term consequences of these strategies? Alternatively, should managers prioritise the attainment of financial results, perhaps at the expense of ESG objectives?

By examining these questions, the research aims to provide valuable insights into how companies can effectively integrate ESG considerations into their strategic planning, thereby achieving a balance between sustainability and profitability. The findings of this study could have significant implications for corporate governance and the future of sustainable business practices.

Why should a Business bother about ESG?

On the surface, this question sounds rhetoric; however, while it is one thing to understand its importance, it is something different for businesses to work upon. The myriad social and environmental challenges this study contended within recent years has pushed ESG issues to the forefront of corporate performance considerations. Climate issues are among the leading portfolio risks for investors and are a significant concern for several stakeholders. An increasing risk in ESG and sustainability regulations and mandatory guidelines globally has been recorded. The release of IFRS S1 and S2 last year suggests that companies operating in jurisdictions where these standards are being considered for adoption must prepare for compliance. Henceforth, incremental knowledge on how managerial decisions, particularly strategy choices, influence ESG performance has become imperative.

Business Strategy: The Link

Business strategy is the combination of a firm's unique idiosyncratic elements and identity, and how these elements are deployed to accomplish organisational objectives and achieve competitive advantage. It is the actions and choices firms adopt to capitalise on contemporary opportunities in accomplishing their corporate objectives.

As a reflection of business strategy, certain sustainability issues may assume higher order of importance akin to a firm's sector and jurisdiction. A rational supposition, therefore, is that all firms will seek to achieve ESG outcomes in one form or another, although at varying levels, given the growing attention on ESG issues. Here is where the consequences of a firm's strategic choices will arguably have significant implications for its ESG outcomes.

Research Aim

The study investigates the relationship between business strategy and ESG performance using Miles and Snow's (1978) strategy typology. It examines how business strategy, as the collective decisions of a firm, impacts its corporate sustainability practices, and the distinct strategy typology that delivers optimum ESG-related outcomes at an aggregate level and across the disaggregated ESG components. This study addresses primarily two major issues:

1. Whether business strategy matters in determining ESG performance; and
2. Which business strategy typology has the greatest impact on ESG performance?

Motivation behind the Study

Firstly, the sparse studies at the intersection of business strategy and ESG-related issues focused only on the dimension of sustainability. Secondly, these studies report evidence based on just two jurisdictions: China and the US. They do not provide operational insights into business strategies across different jurisdictions.

Thirdly, there are conflicting conclusions regarding the strategic typologies that deliver better ESG-related outcomes. Maniora (2018) found that Prospectors are more likely to unintentionally mismanage sustainability issues compared to Defenders. However, Yuan et al. (2020), contrast this by noting that Prospectors are associated with more socially responsible activities and perform better in corporate social responsibility (CSR).

Summary Findings

The study has found evidence that managerial decisions and strategic choices significantly influence the extent of a firm's performance. Therefore, a firm's business strategy has implications for its overall ESG performance, all else unchanged. The study also found that prospector strategy typology (firms that are aggressively innovation driven with a high degree of dynamism in organisational design, structure, and processes, and embracing continuous change) has a greater impact on a firm's ESG performance.

Contributions

1. The project provides first order evidence of the impact of business strategy on ESG performance.
2. The project shows how different ESG pillars and distinct strategy components provide an incremental understanding of the granular effects of business strategy on a firm's ESG performance.
3. It also provides an understanding of the unintended consequences that strategy typology, as a managerial consideration, can exert on ESG performance.
4. Lastly, it highlights the specific strategy typology that can provide managers with an optimum outcome to deliver on their ESG goals.

Business Strategy and Its Typologies

The study conceptualises business level strategy as one of the unique elements of a firm's operational identity and how it deploys such elements to compete within its business environment. Different theories and measures are employed in business strategy research. Porter (1980) has offered two sources of competitive advantage for understanding business strategy - low cost and differentiation, while March (1991) operationalised business strategy based on two organisational learning classifications - exploration and exploitation. Treacy and Weirsema (1995) conceptualise business strategy along the lines of operational leadership, product leadership, and customer intimacy. However, Miles and Snow's (1978) typology has gained prominence as the most widely employed framework and is the selected typology for this study.

Miles and Snow's (M&S) Strategy Typology

The M&S strategy typology is prominent and widely used in business strategy research. It has three main categories of strategy on a continuum:

1. Prospectors: These are innovation-driven businesses with dynamism in organisational design, structure, and processes, and embrace continuous change. They are constantly exploring new products/services to take advantage of market opportunities.
2. Defenders: These businesses seek stability through a narrow product/service market in a stable setting and aim at cost efficiency to carve out a market niche, ensuring good customer relations.
3. Analysers: In the middle are analysers that exhibit features of both prospectors and defenders as they seek to strike a balance between high innovativeness while maintaining high efficiency.

Why is the M&S Typology being used for this Study?

The choice of Miles and Snow (1978) stems from its theoretical and empirical appropriateness for the research investigation for this particular project. This typology establishes the distinctive properties of the collective choices that managers make, aligned with their resources, capabilities, and broader stakeholders' interest.

This alignment is crucial in this study as it combines stakeholder and resource-based theoretical lenses to understand strategic decisions that steer firms' ESG outcomes. It is also operationalised using existing archival data, ensuring replicability and confirmed robustness across time and space.

Prior Literature

The integration of ESG considerations into business practices attributable to increased stakeholders' interest in sustainable corporate behaviour has morphed into consequential strategic matters. Research studies at the intersection of business strategy and sustainability are emerging, albeit only a handful have made attempts to understand how strategic orientations and typologies impact firms' ESG-related outcomes.

Taken together, the specific link between business strategy and ESG performance is still unknown in the literature. Specifically, whether business strategy influences firms' holistic ESG outcomes, and which typology delivers optimum outcomes distinctly and collectively across all ESG dimensions remains an unaddressed empirical matter.

Hypothesis Development (H1)

This study argues that a firms' business strategy, whether conceived from a need to satisfy external interests or a well-crafted intrinsic desire for corporate citizenship, will have implications for its ESG performance. Building on prior literature and consequent on the stakeholder philosophical approach (all else unchanged), firms may thrive to 'do good' if it aligns their interest with stakeholders, such as pursuing positive ESG-related impacts, especially if that sways stakeholders their way.

Our empirical prediction is that if business strategy, as we argue, is a critical success factor in a firms' ESG performance, then there would be a well-established association between the two. In line with the foregoing, we must make our first proposition (in the alternative):

H1: Business strategy is positively associated with ESG performance, all else being constant.

Hypothesis Development (H2)

As a firm's unique differentiator in response to environmental and market situations, business strategy is expected to be heterogeneous across firms depending on where a firm sits on the Miles & Snow's strategy continuum. The resource-based theory offers insights into how strategy typologies might lead to differing ESG performance outcomes. The assumption here is that firms compete based on resources (tangible and intangible). Given that ESG-related engagements involve substantial resources and costs, the extent of stakeholder engagement and the ensuing ESG outcomes would vary depending on a firms' strategy typology.

Collectively, in line with the resource-based perspective, as prospectors seek innovative capabilities that rivals cannot imitate, their drive for ESG outcomes through forward-thinking business strategies and strong governance leading to decarbonisation practices will significantly increase compared to defenders. In light of the preceding arguments, this heterogeneity is expected in ESG performance to lead to better outcomes for prospector firms. Therefore, we make our second proposition (in the alternative):

H2: The association between business strategy typology and ESG performance is strongest for prospector firms.

Sample Selection and Data

1. The sample is comprised of firms on the Refinitiv database over the period 2005-2020.
2. The commencement period reflects the earliest date from which ESG ratings were available in the database.
3. Firms with missing data on ESG and/or firm level characteristics were dropped.

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4. To estimate the strategy measure, a five-year rolling average of the construct variables was required.
5. Therefore, the data used to compute the value of strategy for the first year in our sample, 2010, was from 2005-2009.
6. A final sample of 5,023 firm-year observations based on 2,360 firms across 45 countries was obtained.
7. Country-level data was obtained from the World Bank's World Development Index (WDI) database.

M&S Strategy Measure

This study has employed the M&S strategy typology as it comes with the advantage of being easily operationalised using archival data, in contrast to other measures restricted to surveys and interviews. Six variables over a rolling prior five-year average were employed to construct the strategy measure:

1. Ratio of research and development to sales (RDS5);
2. Ratio of employees to sales (EMPS5);
3. Change in total revenue (REV5);
4. Ratio of selling, general, and administrative expenses to sales (SGA5);
5. Employee fluctuations (StdEMP5); and
6. Capital intensity (CAP5)

All of the above mentioned variables are quintile ranked such that observations in the lowest (highest) quintile are given a score of 1(5), except the CAP5 measure, which is inverted since defenders are more efficient in PPE usage. The scores are aggregated for each firm-year to determine the composite strategy score ranging from 6 to 30.

Scores of

a. 6-12 represent defenders;
b. 13-23 represent analysers; and
c. 24-30 represent prospectors

ESG Performance Measure

Our dependent variable is ESG performance scores obtained from Refinitiv. Refinitiv has one of the most comprehensive ESG databases, covering more than 80% of market capitalisation across over 450 different ESG metrics. The ESG scores are based on company's reported performance, commitment, and effectiveness in ESG-related activities based on information compiled from multiple sources. With over 12,000 companies worldwide, the Refinitiv ESG score has wide coverage and provides comprehensive reflections of a company's ESG activities and is calculated based on a 0 to 100 scale, with a higher value indicating greater sustainability efforts.

Critique

Refinitiv is subject to revision, as new information becomes available, which can lead to potential shortcomings. As part of the sensitivity analysis, Refinitiv's ESG scores have been benchmarked against the S&P Global ESG Scores and find qualitatively similar results.

Further Tests

A range of sensitivity tests are implemented and robustness checks are held to ensure that the findings are not influenced by specific factors and to address concerns regarding endogeneity and model misspecification, including:

1. Business strategy and ESG performance: PSM sample;
2. Prospectors and ESG performance: PSM sample;
3. High emitting prospectors and ESG performance: PSM sample; and
4. Two stage least squares based on instrumental variable to correct for possible endogeneity issues. This is important as omitted variables, reverse causality, and other determinants of business strategy and ESG performance may equally bias the results and affect their reliability.

Collectively, the study found qualitatively similar results with our benchmark model. The results show consistency, with prior estimations, and support the hypothesised relationship between business strategy and ESG performance.

Concluding Remarks

It has been found that there is a positive association between firms' business strategy and ESG performance, emphasising the significant implications of business strategy on firms' overall performance. Specifically, it was observed that a firms' business strategy, on average, influences its ESG performance by 0.83%, all else remaining constant. Secondly, it was found that the strategic choice of a firm has particularly strong implications for its environmental and social performance within the broader ESG performance.

Furthermore, it has been observed that the prospector strategy typology yields a superior ESG outcome compared to other typologies. A range of factors may account for this empirical outcome since prospectors tend to be more adaptable, embracing change and uncertainty in their operations, including significant investments in R&D, as well as possessing great agility and foresight to pursue new opportunities through careful planning and strategic decision making.

Key Takeaways

1. Practically, this study documents how firms' strategic orientations and choices, given their unique source base, provide a differentiator mechanism to improve their ESG performance. Managers seeking to improve their ESG performance, especially in response to stakeholders' demands, can essentially understand the nature of strategic choices needed to successfully address such ESG-related issues.

2. The findings provide valuable insights for resource allocation and decision making related to ESG performance. By identifying the strategy that impacts ESG performance, the study shows how firms can unconsciously commit to objectives that either enhance or hinder their success in non-financial reporting and performance. Following the release of the IFRS Sustainability Standards, managers of firms need to be aware of how their strategy typology will impact their compliance capabilities and thus realign as appropriate.

3. While adopting a business strategy is consequential on the competencies and resources available to an organisation, an understanding of the unintended effects of a chosen strategy is crucial for management's considerations with respect to accomplishing the overarching aims of the business.

4. This study's insights are particularly useful for fund managers and investors seeking to expand their ESG investment portfolios. This knowledge will help them gain firsthand insights into the firms' strategic orientations that can meet their expectations.

Q&A Session

Q. What are your views on the evolving relationship between governance and ESG? Is there a thinking behind this relationship? Have you thought of any mechanism? Is it a measurement issue?

A. When it comes to measurement, we have been testing different ways. I think maybe one thing that may play out will be the construct of the metrics, especially if you don't have that much of a data sample to put into the five-year rolling average. We also feel that since we are tightening the sample to a very specific issue, the ones that do not have variability significantly across the industry may not show up because that is what the business strategy measure actually would do. The likelihood of what is not varying among them will not show up any differentials. We suspect that, but I guess it is still open to more testing and we will try to see what we can do more.

Q. You were talking about M&S methodology, where you were using R&D and capital intensity to measure the strategy. We would expect tech industries to spend more on R&D and they would have more intangible investments, while the energy industry would have more tangible investments. So, tech industries are more likely to come under prospectors and the energy industries are more likely to come under defenders because they are more capital intensive?

A. We try to deal with the endogeneity problem, whether there are already some elements within the strategy measure in trying to construct the six variables into an index. Although, some of them were already captured in the ESG measure and we did the very classical endogeneity tests. But we have even gone for that to do entropy balancing and PCM propensity score matching.

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KLMDC, Heritage Campus, Vastrapur, Ahmedabad - 380 015, Gujarat India

Prof. Anish Sugathan & Prof. Neerav Nagar | Co-Chairpersons | chr-esg@iima.ac.in
Ms. Suganya Sudhakar | Assistant Manager | am-esg1@iima.ac.in | +91-79-7152 7956