Deloitte.

April 2021

Center for Board Effectiveness

On the board's agenda | US

Incorporating ESG measures into executive compensation plans

Introduction

With the 2021 proxy season underway, environmental, social, and governance (ESG) topics are dominating the conversation. While dialog between companies, investors, and other stakeholder groups has accelerated on a variety of ESG topics, the role of ESG in long-term value creation had already been steadily increasing. According to a recent study, investors that collectively manage $17.1 trillion in US-domiciled assets have adopted sustainable investing strategies, which integrate ESG criteria within investment decisions. Sustainable investing has increased nearly 43% since 2018, demonstrating that the incorporation of ESG considerations into investment decisions has gained significant traction.[1] Many companies now recognize that developing and implementing an ESG strategy is more the norm than an exception and are evaluating how best to demonstrate progress through robust measures and enhanced disclosures.

1. Morgan Stanley Institute for Sustainable Investing, "Sustainable Value: How Emerging Public Companies Can Deliver on ESG Expectations," 2020.

Investors have made their ESG expectations known and will likely continue to use their voting power to hold companies accountable for meaningful progress, demonstrated through effective disclosure, on ESG issues in this year's proxy season. For example, in his 2021 annual letter to CEOs, BlackRock CEO Larry Fink reinforced his previous call for companies to align ESG and climate disclosures with leading standards, such as the Sustainability Accounting Standards Board (SASB) and Task Force on Climate-related Financial Disclosures (TCFD). His 2021 letter further emphasized a focus on climate, specifically net-zero strategies, as well as on pertinent talent strategy elements such as diversity, equity, and inclusion. Given this and similar statements, it is not surprising that in 2021, many investors have signaled plans to increase support for shareholder sustainability proposals.

In addition to increasing pressure from investors, greater attention is being given to ESG and climate topics from a policy and regulatory perspective. A number of recent Securities and Exchange Commission (SEC) activities demonstrate how quickly the SEC's attention is shifting around ESG and climate, including the appointment of its first policy adviser for climate and ESG.[2] This announcement was quickly followed by the creation of a Climate and ESG Task Force within the SEC's Division of Enforcement,[3] as well as a published statement from the acting chair directing the Division of Corporation Finance to focus on climate-related disclosures and use the insights gained from the reviews to update guidance.[4] Allison Herren Lee, in her capacity as acting chair prior to the recent confirmation of Gary Gensler as chair of the SEC, requested that investors, registrants, and other market participants provide input on whether current disclosures adequately provide information on climate-related risks, impacts and opportunities.[5] At the global level, the International Financial Reporting Standards (IFRS) Foundation Trustees are proceeding with a strategic plan to stand up a Sustainability Standards Board (SSB) to sit side by side with the International Accounting Standards Board (IASB) to bring sustainability and financial reporting standard-setting under a common architecture, governance infrastructure, and due process. Further, the International Organization of Securities Commissions (IOSCO), of which the SEC is a member, announced support for the IFRS Foundation's proposed SSB and committed to redouble efforts in contributing to the urgent goal of improving the completeness, consistency, and comparability of sustainability reporting. The SEC has also been named to co-chair the IOSCO Technical Expert Group to advise on standing up the SSB.

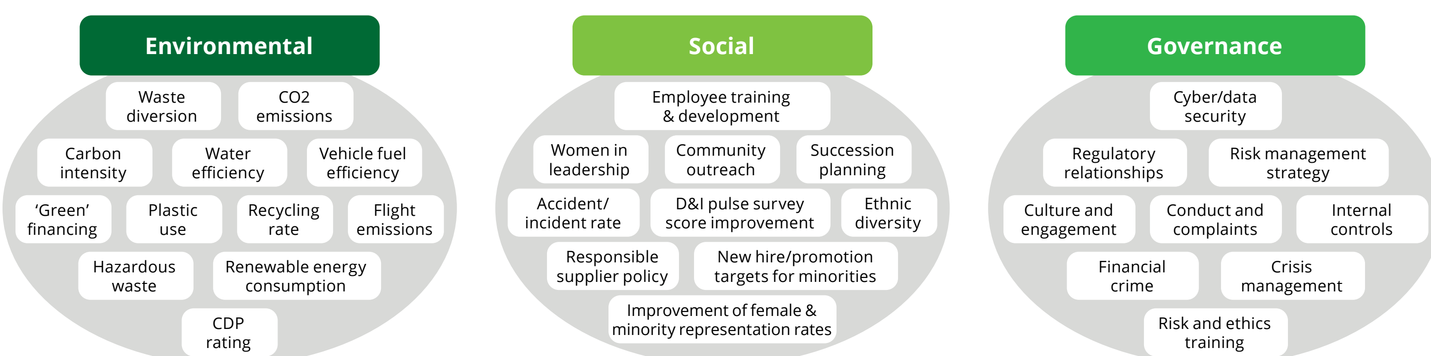
In the meantime, investors and other capital markets players will almost certainly continue to elevate their expectations when it comes to a company's ESG progress, and boards will need to be responsive. But how will companies demonstrate their commitment to these strategies, and how will boards hold management accountable for meaningful progress against the company's goals? One possibility is the incorporation of ESG performance measures in executive incentive plans, which will surely be the subject of consideration and discussion this year and in years to come.

Executive accountability: Linking ESG measures to incentive arrangements

As investors', regulators', and other stakeholders' demands for corporate ESG responsiveness continue to grow, more and more board members have discussed whether ESG measures should be incorporated into executive incentive plan designs to highlight how management will be held accountable for ESG results.

Financial measures have long been the predominant component of annual executive incentive plan designs. Such measures include the achievement of revenue, EBIT/EBITDA, EPS, or cash flow goals. In long-term incentive performance award plan designs, measures like total shareholder return, EPS, revenue, and return on invested capital and net assets have been used to determine award payouts. When it comes to incentivizing executive results, there is no argument that incorporating transparent financial measures into executive incentive arrangements is a reasonable way to reward executives for driving value. However, given evidence that positive ESG results can drive long-term shareholder value, it seems likely that executive incentive plan designs will increasingly include "quantifiable" ESG measures.

Based on a recent Deloitte review of proxy statements filed between February 2020 and January 2021, less than 40% of the Fortune 100 companies have incorporated ESG measures in their executive incentive plans. Of those companies that have used ESG measures in their annual incentive plan, the most common ESG category falls under the "S," Social, followed by "E," Environmental. Additionally, Deloitte's review found that measures tied to human capital/culture and diversity, equity, and inclusion are by far the most common type of measures found in annual incentive plans. Below are some sample ESG measures found in executive incentive plans:



2. https://www.sec.gov/news/press-release/2021-20.
3. See "SEC Announces Enforcement Task Force Focused on Climate and ESG Issues," "SEC Division of Examinations Announces 2021 Examination Priorities," and acting SEC chair Allison Herren Lee's "Statement on the Review of Climate-Change Disclosure."
4. Multiple references available, such as https://www.reuters.com/article/us-climate-change-disclosures-idUSKBN2AI2CG or https://www.nasdaq.com/articles/secs-coates-says-agency-should-help-create-esg-disclosure-system-2021-02-18.
5. https://www.sec.gov/news/public-statement/lee-climate-change-disclosures?utm_medium=email&utm_source=govdelivery.

Given the external factors discussed earlier, it seems likely that more boards will seek to hold executives accountable for ESG results through the use of incentive arrangements. As long as there is a balanced approach to the types of measures used in incentive plan designs, using incentives as a means to reward executives for driving ESG outcomes (or penalizing them for failing to achieve ESG objectives) can benefit shareholders and further promote a pay-for-performance philosophy that aligns with creating long-term, sustainable value.

A balanced approach to performance measures

The performance measures used in incentive awards should reflect the short- and long-term objectives of the organization. Companies should consider using a mix of financial and non-financial measures to minimize over-emphasis on one area. At the same time, performance measures should have sufficient weighting or influence over an incentive payout opportunity in order to promote the importance of that measure.

Compensation committees not only have the responsibility of reviewing and asking management to explain how incentive plan measures for executives tie to and help reinforce the company's strategy and culture, but should also ask for confirmation that incentive plan goals for all other employee groups serve to reinforce the objectives and values of the organization and reflect a responsible balance of risk and reward.

In addition to selecting the appropriate financial measures, there is much to consider when determining which ESG measure or group of measures should be used to incentivize executives for results. Below are some key questions and considerations that the board and management can discuss when determining the appropriate ESG measure(s) to include in executive incentive arrangements:

- **What are the company's relevant ESG topics or issues?** Engaging with stakeholders on ESG is a fundamental starting point for companies as they seek to identify, manage, and integrate ESG into the business strategy. Performing a periodic ESG materiality assessment, and supplementing with ongoing stakeholder engagement activities, enables companies to have a multistakeholder view of priority ESG topics for the business.
- **Which ESG topics or issues have the greatest impact on enterprise value creation?** Degree of financial consequence for the business may vary by ESG topic or issue. Aligning and driving ESG integration into a company's purpose, strategic planning, enterprise risk management activities, and resource allocation requires prioritization of certain issues over others. It is important for businesses to work cross-functionally to fully understand the risks and opportunities associated with each ESG topic or issue.
- **How is ESG performance measured and is the information reliable?** There is a clear marketplace mandate for standardization of ESG performance measures. Companies that have identified priority topics may look to leading global standards and frameworks as a starting point for monitoring and reporting on performance, allowing for enhanced comparability across peers and marketplace leaders. As mentioned previously, progress is underway towards the development of a global Sustainability Standards Board and potential set of globally comparable and consistent standards, which will facilitate performance evaluation against peers and across the marketplace. Further, obtaining assurance can be important in signaling confidence in the quality of ESG disclosure to the market and giving both external stakeholders and decision-makers more confidence in its integrity. Third-party assurance, on a limited or reasonable basis, can be provided by a company's financial statement auditor, who can also bring insights on how companies can evolve their focus on ESG to meet the increasing demands of investors and other stakeholders.
- **What is the appropriate time horizon for measuring ESG priorities?** Many companies talk about "progress toward" certain objectives, given the longer-term nature of achieving ESG results. Typical time horizons for ESG measures are in the three-to five-year in order to conduct trend analyses, though climate-related issues may warrant a much lengthier view (10 years and longer). Where companies decide to incorporate ESG measures into annual incentive plans for executives, they can measure progress toward longer-term objectives when ESG goals cannot be measured over a 12-month period.

After the board and management agree on the type(s) of ESG measure(s) to include in the executive incentive plan, they will need to determine the best way to reward (or penalize) executives for driving ESG results. Examples of how to incorporate ESG measures in the incentive plan design are below:

Type performance measure design	Description
Stand-alone	A quantifiable measure linked to a stand-alone weighting (e.g., 10% to 20%) in the plan. The measure will include predefined goals at threshold, target and maximum performance, and corresponding payout opportunities. As long as sufficient weighting is applied, this type of approach sends a strong message to shareholders that the company is serious about holding executives accountable for results.
Scorecard (mix of measures)	Four to five measures that are linked to a defined weighting in the plan. The assessment of measures can be reviewed on an individual basis or in the aggregate. However, it is a leading practice to include quantifiable measures that provide transparency to the executives on what they will be held accountable for by the board. The overall result of performance measure(s) determines the incentive payout opportunity. Companies that are early in their journey of incorporating ESG measures into their executive incentive plans will typically use the scorecard approach.
Performance modifier	A measure used to increase or decrease the overall award payout. A modifier can range between +/- 10% to 20% and should factor in the rigor behind the measure. Once again, the measure should be quantifiable, as it provides transparency to shareholders on what results are needed to determine increasing or decreasing the overall incentive payout. To the extent an ESG measure is too hard to quantify in the early years of adoption and the board wants shareholders to understand the importance of holding executives accountable for (and making progress toward) the measure, the company may want to consider only using downward discretion (e.g., 10% of the incentive payout will be reduced if progress toward goals are not made).
Underpin (also known as a "hurdle," "trigger," or "tripwire")	A measure that needs to be achieved before the incentive plan formula kicks in, which is typically quantifiable. Although historically, the underpin approach has been used with financial measures, incorporating ESG underpin measures signifies to shareholders that the measure is the starting level of performance that must be met before the full incentive plan formula begins, which also helps management understand the importance placed on the measure. In the event that an underpin approach is used, it is important that the performance measure is not viewed as a "slam-dunk" or "sandbagged" goal.

Deloitte's review of the Fortune 100 companies' proxy statements found that the most common approach used to evaluate ESG measures in executive annual incentive plans is by far the scorecard approach, followed by a modifier and stand-alone measure. Deloitte also found that these companies typically evaluate ESG measures in incentive plans on a qualitative basis. These market observations are most likely due to the early journey of companies incorporating ESG measures in their incentive plans, as well as there being many areas for companies to focus on with respect to driving ESG results and not wanting to place importance on one area to the potential perceived detriment of another. As companies become more mature in their ESG journeys, it is likely that the future incentive design trend will be to continue to use a scorecard approach that enables boards to evaluate ESG performance on a quantifiable basis or perhaps focus on up to three ESG measures that will be treated as stand-alone goals in the incentive plan.

Communicating progress on ESG metrics with stakeholders

Communicating a company's ESG story can be done effectively by providing high-quality, consistent, reliable disclosure. However, determination of goals, integration with executive compensation plans, and measuring achievement is a team effort between management and the board and its committees. While the full board may take the lead in the oversight of the company's strategy, including the integration and execution of ESG, the audit, compensation, and nominating and governance committees each have an oversight role as it relates to ESG and executive compensation, requiring them to carefully coordinate when executive incentives are used to drive ESG outcomes and oversee the reliability of information used to determine success.

Optimal communications around the importance of ESG and its role in the company's executive compensation program requires coordination among the company's legal, finance, investor relations, and communications teams. While the proxy statement provides a vehicle for companies to communicate a robust and transparent view of collective board oversight of ESG and executive compensation, companies may also seek to demonstrate the importance the board places on ESG during regular engagement with investors, as well as other communications, including to the general public.

Conclusion

With increased regulatory attention on ESG, continued investor focus, the potential for a new Sustainability Standards Board on the horizon, and the US regulatory agenda taking shape, it is clear that companies will need to be thoughtful about their ESG strategy and how it is communicated to stakeholders. Incorporating ESG performance, measured through a reporting process that demonstrates an effective governance and control environment, into executive incentive plans is a way for the board to hold management accountable for progress against the strategy, as well as signal its importance to stakeholders. Although it appears that this practice is still evolving, market developments indicate that it may not be long before it becomes a more common occurrence and boards will need to be ready to respond.

Authors

Kristen Sullivan
Audit & Assurance Partner
Sustainability and KPI Services
Deloitte & Touche LLP
ksullivan@deloitte.com

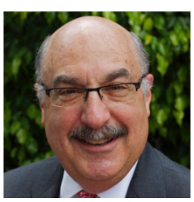
Tara Tays
Managing Director
Deloitte Consulting LLP
ttays@deloitte.com

Jenny Lynch
Senior Manager
Deloitte & Touche LLP
jelynch@deloitte.com

Center for Board Effectiveness

Maureen Bujno
Managing Director and
Audit & Assurance Governance Leader
Center for Board Effectiveness
Deloitte & Touche LLP
mbunjo@deloitte.com

Leeann Galezio Arthur
Senior Manager
Center for Board Effectiveness
Deloitte & Touche LLP
larthur@deloitte.com



Bob Lamm
Independent Senior Advisor
Center for Board Effectiveness
Deloitte LLP
rlamm@deloitte.com

Contact us

Carey Oven
National Managing Partner
Center for Board Effectiveness
Chief Talent Officer, Risk & Financial Advisory
Deloitte & Touche LLP
coven@deloitte.com

Audrey Hitchings
Managing Director
Executive Networking
Deloitte Services LP
ahitchings@deloitte.com

Debbie McCormack
Managing Director
Center for Board Effectiveness
Deloitte LLP
dmccormack@deloitte.com

Krista Parsons
Managing Director
Center for Board Effectiveness
Deloitte & Touche LLP
kparsons@deloitte.com

About the Center for Board Effectiveness
Deloitte's Center for Board Effectiveness helps directors deliver value to the organizations they serve through a portfolio of high quality, innovative experiences throughout their tenure as board members. Whether an individual is aspiring to board participation or has extensive board experience, the Center's programs enable them to contribute effectively and provide focus in the areas of governance and audit, strategy, risk, innovation, compensation, and succession.