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2022 Use of Environmental, Social, and Governance Measures in Incentive Plans

FW COOK

2022 USE OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) MEASURES IN INCENTIVE PLANS

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INTRODUCTION

There is general agreement among stakeholders that companies benefit from strong environmental, social, and governance (ESG) practices. Accordingly, ESG metrics are continuing to gain prevalence within the largest companies' incentive compensation plans. As demand increases, ESG metrics are gaining traction and expanding beyond the industries that have historically utilized them (i.e., Energy and Utilities sectors). Additionally, the scope of ESG metrics has broadened from traditional measures such as environmental and safety goals to social goals, such as diversity and inclusion and human capital measures. Alongside this movement, investor focus has shifted to transparency around ESG metrics, goals, and rigor.

Currently, the most common approach to incorporate ESG measures into executive compensation plans is to add them into incentive plans. Given this context, FW Cook analyzed current executive annual bonus and long-term incentive plan practices among the top 250 U.S. public companies by market cap with a focus on:

1. Prevalence of ESG metrics within executive short-term and long-term incentive plans
2. Prevalence by industry
3. Types of ESG metrics, broadly
4. Types of diversity and inclusion metrics
5. Approaches to incorporating ESG within incentive plans
6. Achievement disclosure practices

Summary of Key Findings
74% of the largest companies disclose ESG measures in incentive plans (up from 64% in 2021). The vast majority of these companies incorporate ESG metrics in the annual incentive plan, but a few also incorporate ESG in a long-term incentive plan.
The prevalence of ESG metrics in incentive plans varies significantly by industry and is most prevalent among companies in the Energy, Utilities, and Materials sectors (>80% prevalence). Such metrics are least prevalent among companies in the Consumer Discretionary sector (<65% prevalence).
The types of ESG metrics employed vary by industry. Environment & Sustainability metrics are most common among the Energy and Utilities sectors, while Human Capital & Culture and Diversity & Inclusion metrics are generally most common among other industries. This year we observed a particular increase in the number of companies using diversity and inclusion metrics (58% in 2022 compared to 43% in 2021).
69% of companies with Diversity & Inclusion metrics provided specific and detailed goals, while 31% of such companies used broader goals. The most common Diversity & Inclusion metrics are goals surrounding diverse leadership representation, promotions and hiring of diverse employees across the entire company, and diverse representation across the entire organization.
The most common approach to incorporate ESG metrics is to include the goals into a broader assessment of individual performance.
Companies continue to disclose performance against ESG incentive measures on a qualitative basis, with less than a quarter of companies that use ESG incentive measures disclosing quantitative performance achievement.

FW COOK COMMENTARY

FW Cook believes that companies' incentive plan design should be driven by business strategy, rather than by external expectations around compensation design. Nonetheless, our clients are actively discussing how best to signal to investors and other stakeholders the importance of ESG objectives. As companies develop their ESG goals, they strive to demonstrate alignment with business strategy, progress against articulated goals, and management accountability.

Furthermore, while companies recognize that there is widespread external interest in ESG, there is concern about the most appropriate way to introduce ESG metrics into incentive plans and avoid unintended consequences, which may include:

- Pressure to set highly aspirational and potentially unachievable goals to demonstrate commitment,
- Embarrassment and criticism in the event of underachievement,
- Criticism from the proxy advisory firms and governance professionals for subjective measurement,
- Suboptimal short-term reaction to longer-term challenges, and
- Questions from investors and other stakeholders about the importance (or lack thereof) of excluded metrics.

As companies begin planning for 2023, it is appropriate to evaluate some key questions and factors regarding ESG and its inclusion in incentive plans:

1. ***Status of Current Processes*** - Does the company have a measurement system to accurately track ESG metrics? Does the governance structure assign ESG responsibilities to a specific board committee or multiple committees?
2. ***Signaling of Importance*** - Does the importance of ESG require its formal inclusion in incentive plans, or can ESG be effectively measured and disclosed outside of the plans? Does inclusion of specific ESG goals unintentionally imply others are unimportant?
3. ***Measurement of ESG Goals*** - Should ESG goals be independently weighted metrics, incorporated as a modifier, or a part of team-wide or individual discretionary decisions? Can stand-alone, achievable goals be set that foster progress? Is it important to preserve flexibility as circumstances evolve?
4. ***Balancing Multiple Stakeholder Perspectives*** - What are the business implications of including an ESG metric, recognizing that not all stakeholders embrace the same investment strategy, social agenda, or time horizon? What ESG metrics are most important to investors? If an ESG metric is included, which financial metric is de-emphasized (i.e., weighting reduced)? Is there willingness to disclose the specifics of ESG incentive metrics? Once in the incentive plan, can an ESG metric be removed?
5. ***Diversity & Inclusion Goal Setting*** - The prevalence of diversity, equity, and inclusion goals continues to increase, and it is important to consider whether D&I goals should be set to measure outcomes or activities and inputs. How will this approach change over time? How does the type of goal affect the way progress is viewed by employees, investors, and other stakeholders?
6. ***Goal Setting Period*** - Because progress on many ESG metrics will evolve over long periods (e.g., a decade or more, especially for climate change initiatives), it is natural to want to measure ESG performance in long-term plans. But does the company have forecasting precision over periods as short as three years? If discretion in measurement is retained on an equity-based, multi-year incentive plan, is the company willing to accept variable accounting on the award? To reduce the impact of variable accounting, should ESG metrics apply exclusively to top level executives in a long-term plan? If lower-level executives are excluded, does it raise questions about the importance of the metric and/or accountability across the organization?
7. ***Disclosure*** - What level of disclosure can be provided? Are goals able to be disclosed quantitatively? Will greater detail open the company up to criticism for insufficiently ambitious targets or poor achievement versus stretch goals? Conversely, will less detail expose the company to criticism from proxy advisory firms and investors?
8. ***Unintended Consequences*** - If one ESG metric is chosen over others, does it miscommunicate the degree of importance placed on the metrics not chosen? If qualitatively assessed, does this create the potential for criticism from proxy advisors? Does underachievement or setting a target goal below investor aspirations create possible public relations challenges or inconsistency with the company's Corporate Sustainability Report? Might possible underachievement attract moral criticism to the company, and could this risk encourage suboptimal decision making?

INSTITUTIONAL INVESTOR ESG EXPECTATIONS

While the adoption of ESG metrics into compensation plans continues to gain prominence among publicly-traded companies, institutional investors have not yet adopted a prescriptive set of expectations on ESG measure inclusion.

Large index fund managers — Vanguard, Blackrock, and State Street — all note that they do not hold strong views about whether ESG measures should be included in executive compensation programs. Institutional investors are primarily concerned with how ESG measures are implemented in the event companies include them in their compensation plans, expecting targets to be clear and tied to long-term strategy while also being measurable and transparent.

METHODOLOGY

FW Cook conducted a study of the use of ESG measures in annual and long-term incentive plans among the largest U.S. public companies, consisting of 250 U.S.-listed companies in the S&P 500 with the largest market capitalizations as of March 31, 2022 (excluding Foreign Private Issuers that do not have the same disclosure rules). The industry breakdown is as follows:

Sector	Cos.
Communication Services	11
Consumer Discretionary	21
Consumer Staples	22
Energy	16
Financials	32
Health Care	38
Industrials	31
Information Technology	40
Materials	12
Real Estate	14
Utilities	13
Total	250

Data were sourced from the latest proxy filings (as of September 1, 2022) and represent annual and long-term incentive programs in place during fiscal year 2021/22.

METHODOLOGY

For purposes of this report, we grouped ESG measures into the seven broad categories below:

	Environmental	Social			Governance		Broad ESG
Category	**Environment & Sustainability**	**Human Capital & Culture**	**Diversity & Inclusion**	**Health & Safety**	**Governance**	**Cybersecurity & Data Protection**	**Overarching ESG**
Example of Measures	Reduction in carbon emissions Waste reduction Environmental stewardship	Employee engagement Succession planning Recruitment and retention Employee training and development Transforming culture	Gender representation Racial minority representation Inclusion survey	Fatalities Lost workdays Accident prevention Food or product safety	Regulatory compliance and internal controls Risk management processes Stakeholder engagement All-encompassing governance enhancements	Cybersecurity Fraud prevention Data governance	Implement overarching ESG or corporate responsibility strategy Recognition for ESG initiatives High ESG scores from external ratings agencies

Note - Our study excludes any measures that are not intended to be ongoing. For example, measures in place as a response to COVID-19 or any other one-time event are interpreted as one-off and are therefore not included in this study capturing ongoing changes to incentive plans.

METHODOLOGY

The various methods of ESG incorporation and degree of disclosure were categorized as follows:

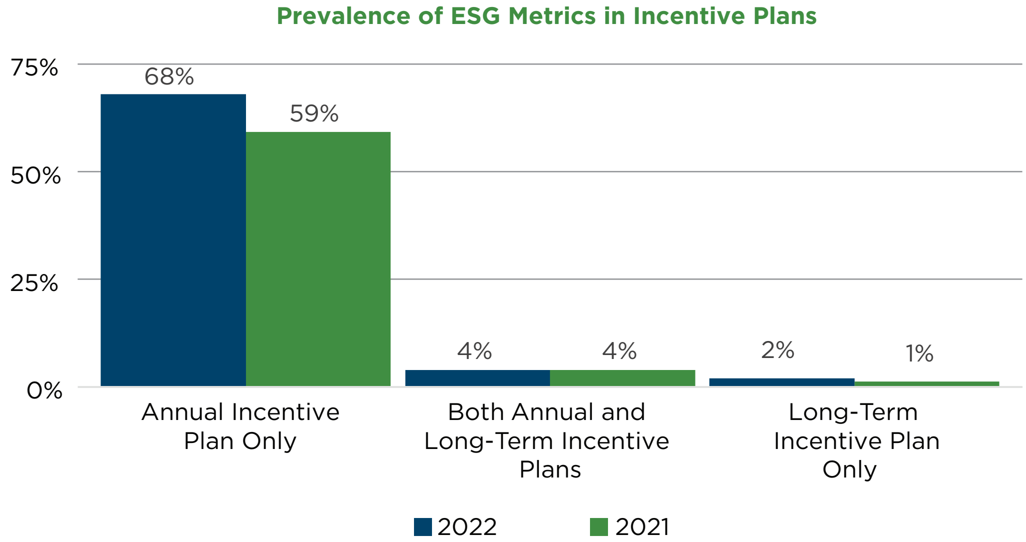
ESG Measurement Approach			
Individual Performance	**Team-Wide Strategic Performance**	**Stand-Alone Metric**	**Stand-Alone Modifier**
ESG metrics are incorporated into a broader assessment of individual performance. The particular ESG metrics and/or achievement against the ESG objective may vary by Named Executive Officer	ESG measures are incorporated into a scorecard of objectives by which all Named Executive Officers are evaluated. The ESG measures are not a formally weighted component of the scorecard and instead are typically considered as part of a holistic evaluation of performance used to determine payouts	ESG measures are a weighted component of the program and are individually considered in the determination of the incentive plan payout	ESG measures that are not included in the core plan design that are secondarily applied to increase or decrease the overall award payout

Disclosure of ESG Performance		
No ESG-Specific Performance Disclosure	**Qualitative Performance Disclosure**	**Quantitative Performance Disclosure**
ESG measures are listed among the factors that are considered in arriving at an incentive payout, but specific performance achievements are not described. Most common among companies using ESG qualitatively as an individual performance consideration	ESG performance is described qualitatively without any quantitative performance results disclosed. Includes companies that disclose a payout score for ESG without disclosing the underlying quantitative performance that was used to calculate the payout	ESG performance that was considered in arriving at a payout is disclosed quantitatively. Most common among companies using a formulaic ESG metric or modifier
Note – It is possible to evaluate ESG performance quantitatively using pre-established goals but disclose the performance achievement qualitatively or not specifically describe achievement at all.		

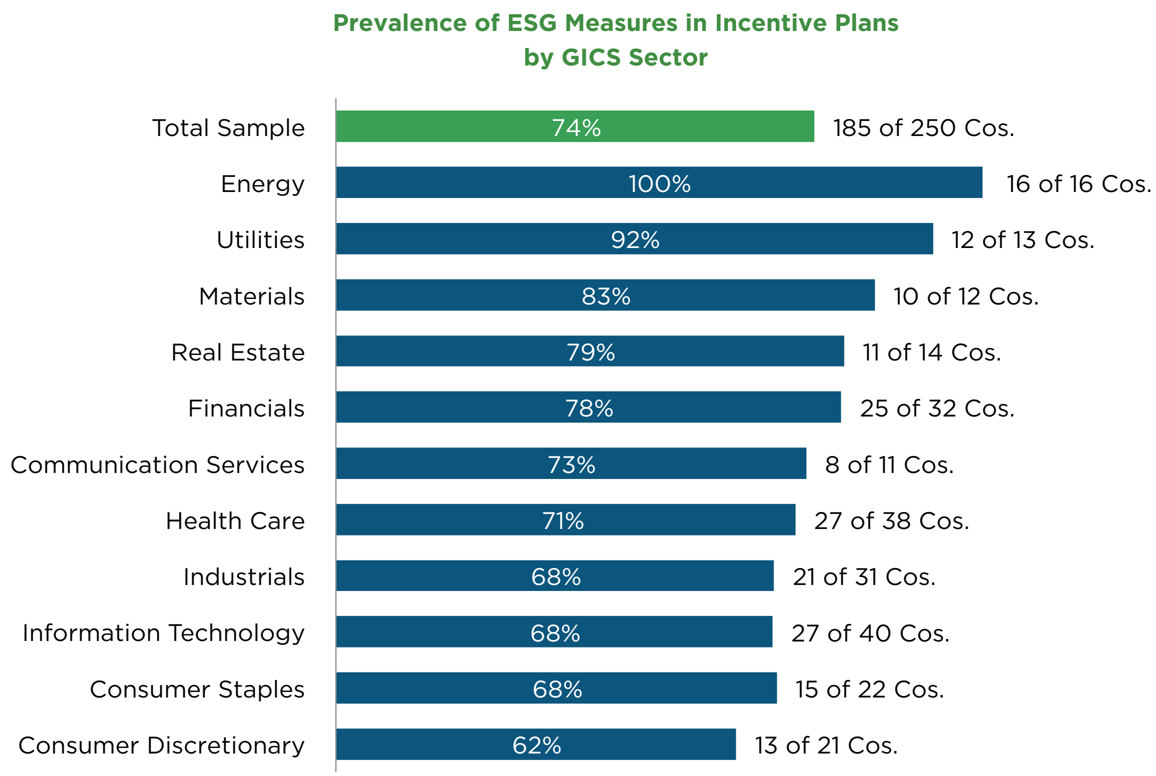
KEY FINDINGS

Prevalence of ESG Metrics

In this year's study, 74% of companies use one or more ESG measures in the annual and/or long-term incentive plan compared to 64% of companies in 2021. Most companies incorporate ESG measures in the annual incentive plan, with low prevalence in long-term incentive plans.

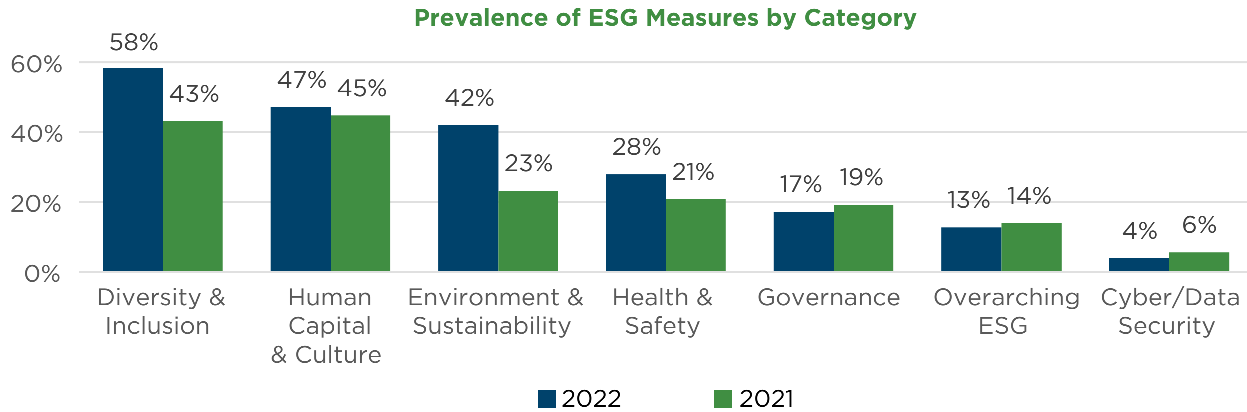


The prevalence of metrics varies among sectors; however, at least 50% of companies in each sector incorporated ESG metrics. ESG metrics are most prevalent among Energy and Utilities companies (consistent with last year's analysis and historical practice).



TYPES OF METRICS

Human Capital & Culture and Diversity & Inclusion continue to be the two most common ESG categories used in incentive plans. For the second straight year, Diversity & Inclusion metrics saw the largest year-over-year increase in prevalence (increasing from 31% in 2020 to 43% in 2021 to 58% in 2022).



The types of ESG metrics used vary significantly by industry sector:

- The Energy and Utilities sectors have high prevalence (>50%) of incorporating metrics tied to Environment & Sustainability and Health & Safety, which have been long-standing metrics in these sectors.
- Human Capital & Culture and Diversity & Inclusion are commonly used across all industry sectors, and the inclusion of these metrics has increased year-over-year.

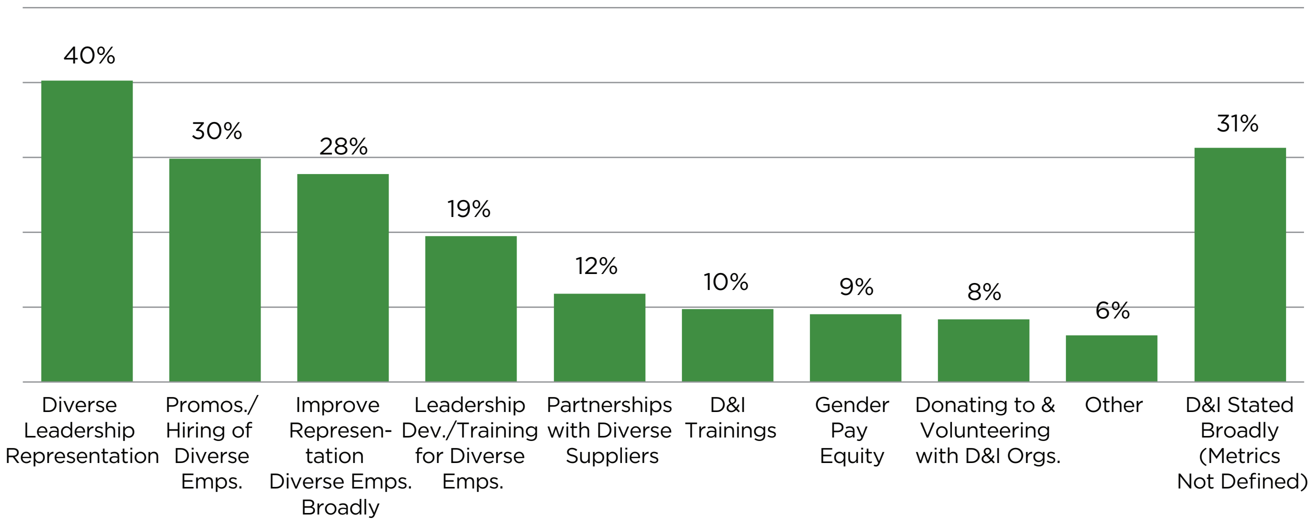
Industry	Human Capital & Culture	Diversity & Inclusion	Environment & Sustainability	Health & Safety	Governance	Overarching ESG	Cyber/Data Security
Communication Services	45%	64%	18%	18%	0%	9%	9%
Consumer Discretionary	52%	52%	29%	24%	0%	0%	0%
Consumer Staples	36%	45%	27%	14%	5%	0%	0%
Energy	31%	50%	100%	88%	19%	19%	0%
Financials	69%	78%	34%	6%	34%	19%	6%
Health Care	61%	55%	32%	18%	26%	16%	8%
Industrials	35%	52%	45%	52%	26%	13%	3%
Information Technology	43%	58%	30%	10%	10%	15%	5%
Materials	33%	58%	67%	42%	8%	17%	0%
Real Estate	57%	57%	50%	7%	21%	21%	7%
Utilities	31%	77%	85%	85%	15%	8%	0%

TYPES OF METRICS

Diversity and Inclusion Metrics

69% of companies with Diversity & Inclusion metrics provided specific and detailed goals, while 31% of companies disclosed they had broad D&I goals. The most common Diversity & Inclusion metrics are goals surrounding diverse leadership representation, promotions and hiring of diverse employees across the entire company, and diverse representation across the entire organization.

Prevalence of Diversity and Inclusion Metrics



Note - Prevalence sums to greater than 100% because some companies incorporate multiple diversity and inclusion metrics into incentive plans.

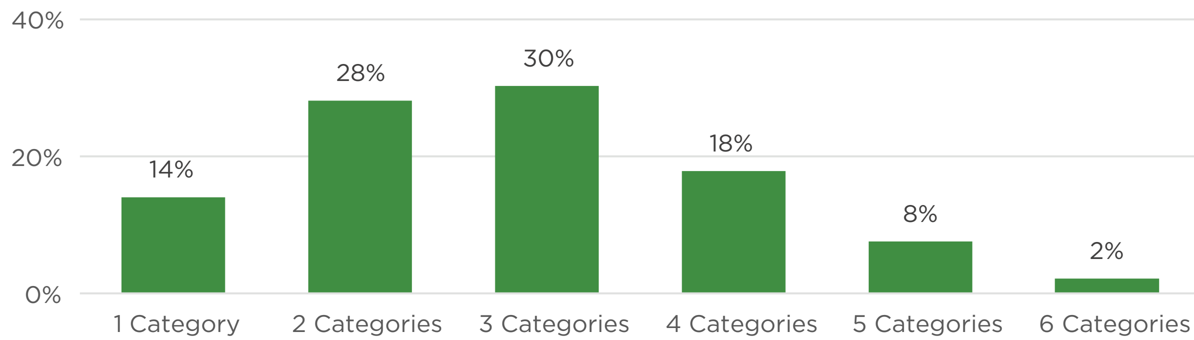
HOW ESG METRICS ARE INCORPORATED INTO INCENTIVE PLANS

The majority of companies incorporate metrics from two to three ESG categories within their incentive plans and measure performance on a qualitative basis.

Number of ESG Metrics

Most companies in our sample cover between two and three different ESG categories in their incentive plans, which suggests that companies are focusing on select ESG categories rather than ensuring all categories are covered.

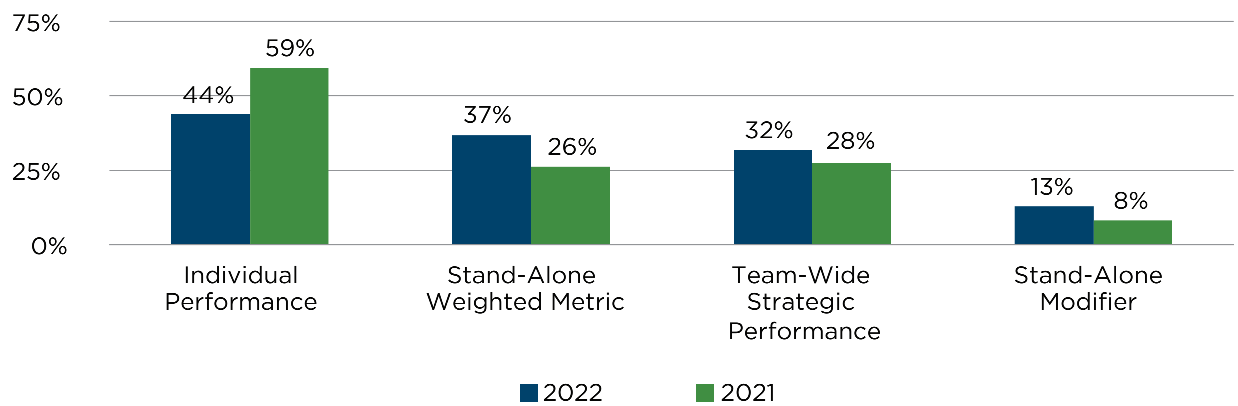
Number of ESG Metrics by Category (Among Companies using ESG metrics)



ESG Measurement Approach

Over the last fiscal year, the most common approach to incorporating ESG metrics has been including the goals in a broader assessment of individual performance. While individual performance continues to be the most used method, individual performance goals decreased in prevalence from the prior year, while stand-alone metrics increased in use. This suggests that some companies may be responding to proxy advisory firms' and institutional investors' preference for more quantifiable and measurable ESG metrics.

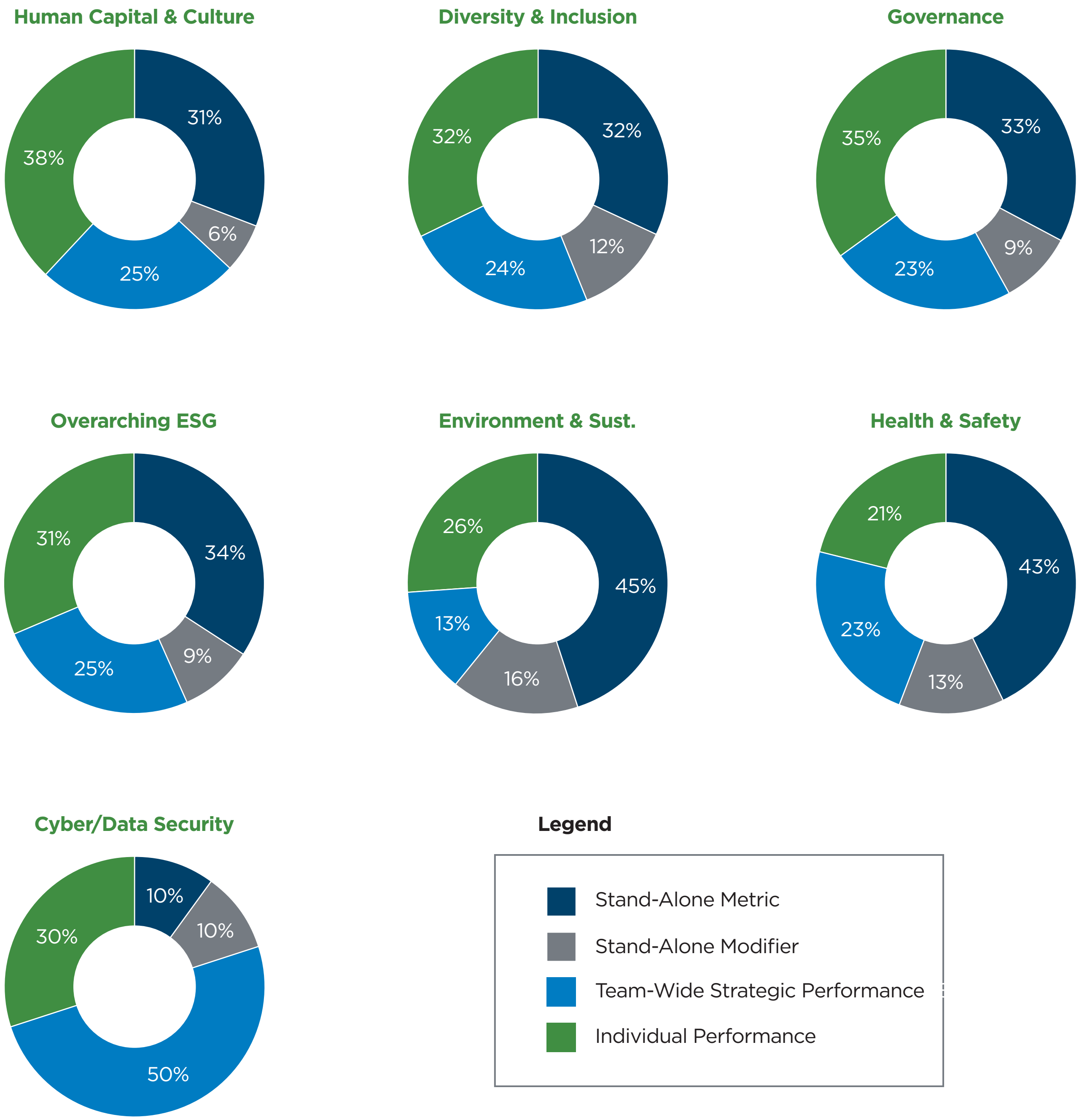
Prevalence of ESG Incorporation (Among Companies using ESG Measures)



Note – Prevalence sums to greater than 100% because some companies incorporate ESG into incentive plans in more than one way (e.g., a company may use one stand-alone ESG measure in addition to an ESG metric as part of an individual performance assessment).

HOW ESG METRICS ARE INCORPORATED INTO INCENTIVE PLANS

The following exhibit presents a breakdown of ESG measurement approaches in incentive plans by metric type. The most notable increases from the prior year include an increase in stand-alone weighted diversity and inclusion metrics.



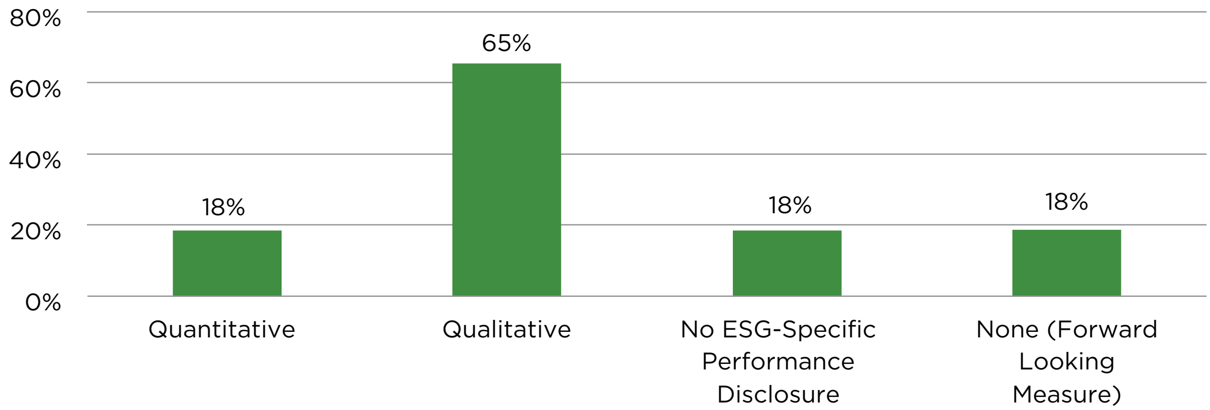
Note – Cases where companies incorporate the same ESG category in more than one way (e.g., stand-alone metric and individual), are counted according to their most impactful incorporation of ESG (i.e., stand-alone metric > stand-alone modifier > scorecard > individual).

HOW ESG METRICS ARE INCORPORATED INTO INCENTIVE PLANS

ESG Performance Disclosure

Only 18% of companies using ESG measures disclosed the performance achievement used to arrive at an incentive payout in a quantitative manner, consistent with our findings last year. Companies are still most commonly describing the performance achievement qualitatively (e.g., met/exceeded expectations, improved relative to last year, etc.). Eighteen percent of companies did not specifically describe how they performed on a given ESG measure, only noting that the measure was considered in arriving at the payout (most common for companies that use ESG measures as part of individual performance assessments). Another 18% of companies had no disclosure because the company disclosed the metric will be in their plan for the following year, and achievement disclosure will be available in next year's proxy statement.

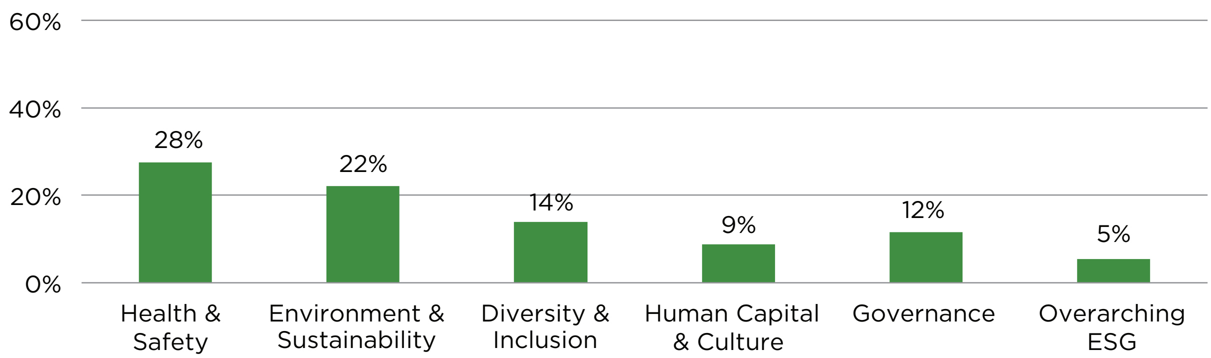
Disclosure of ESG Performance Achievement



Note - Prevalence sums to greater than 100% because some companies disclose performance in different ways for different ESG measures (e.g., quantitative disclosure for one measure and qualitative disclosure for another).

The most prevalent ESG categories that are measured quantitatively are Health & Safety and Environment & Sustainability metrics. Within the Diversity & Inclusion metric category, measures that are typically measured quantitatively include (but are not limited to): diverse leadership representation, promotions and hires of diverse employees, diversity across the entire organization, partnerships with diverse suppliers, gender pay equity, and donations to D&I organizations and causes.

Quantitative Performance Disclosure by ESG Category



ENDING REMARKS

In response to growing stakeholder expectations surrounding ESG inclusion in compensation plans, many companies are eager to move forward with including such metrics and rewarding leaders who cultivate a more inclusive and diverse workplace. The use of ESG metrics in incentive plans continues to increase in prevalence among the largest companies. As anticipated in advising clients on this topic, the prevalence of diversity and inclusion metrics has increased year-over-year as well as the use of stand-alone metrics. Quantitative measurement has also increased in use; however, qualitative measurement remains as the majority practice. Overall, the incorporation of ESG goals into compensation plans is an evolving topic, and there is no universal approach that works best for all companies. Companies should evaluate their unique business objectives, industry, company maturity, investor views, culture, and a variety of other considerations when building ESG metrics into incentive plans.

FW COOK PROFILE

FW Cook is an independent consulting firm specializing in executive and director compensation and related corporate governance matters. Formed in 1973, our firm has served more than 4,000 companies of divergent size and business focus from our offices in New York, Chicago, Los Angeles, San Francisco, Atlanta, Houston, and Boston. We currently serve as the independent advisor to the compensation committees at a substantial number of the most prominent companies in the U.S.

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