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How ESG Metrics Are Taking Over Annual Incentive Plans

Incorporating nonfinancial measures into executive annual bonuses can be beneficial, but intention and transparency are key

By Gretchen Lenth | April 22, 2024

Compensation committees at S&P 500 companies are increasingly tying annual bonuses to measures beyond financial performance. The inclusion of environmental, social and governance goals in short-term incentive plans has increased fourfold since 2019, according to data collected from proxy statements.

Experts say these nonfinancial metrics can serve as useful motivators as companies aim toward specific goals. However, transparency is key to prevent shareholders from feeling left in the dark.

"It makes it difficult for shareholders to understand how performance is translated to payouts when you don't have that clear target," said **Maria Vu**, senior director of compensation research at **Glass Lewis**.

Changing Strategies

Short-term incentive awards earned by company executives tend to be a fraction the size of their long-term counterparts, though annual incentives are largely delivered in cash rather than equity. Payout size is usually calculated as a percentage of the executive's base salary, and the amount rewarded is determined by progress toward goals set by the compensation committee the year before.

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In 2022, 40% of the S&P 500 included at least one nonfinancial goal in their annual incentive plans. The overall number of metrics used to calculate annual bonuses has likewise increased — from 1,500 to over 2,300 — and committees are getting more creative with how they measure progress beyond revenue or earnings per share.

A research paper published in March by **Compensation Advisory Partners** tracked the trends in annual incentive plans at 120 large U.S. firms. Of those analyzed, over half used nonfinancial goals — also known as strategic goals — and the number of firms using three or more metrics has grown.

During their study, researchers at CAP wanted to learn whether using four or more metrics — financial or not — would result in higher payouts by acting as a "fudge" factor.

"It was helpful telling us that's not the case," said **Melissa Burek**, a partner at CAP and one of the authors of the study. "It's not being used as a plug to get bonuses."

The payout distribution of companies using four or more metrics is similar to those using just one or two. A quarter of all companies in both categories paid out somewhere between threshold and the target, while roughly 65% received payouts above target.

Compared to financial metrics, measuring progress toward a strategic goal is more open-ended. In some cases, these goals aren't tracked quantitatively at all.

Even though nonfinancial metrics — especially ESG metrics — are commonly qualitative, companies do their best to place structure around their evaluations, said **Michael Bonner**, another CAP partner who co-authored the study.

"When companies are putting in ESG metrics, from our perspective, they are viewing that as a critical piece of their going-forward strategy," Bonner said.

Types of nonfinancial metrics

A company's business goals are ultimately what informs the metrics used in annual incentive plans. Human capital metrics are the most common because they're relevant across industries.

However, the specific human capital issues tackled have shifted. Measures related to safety have remained popular, but 12% fewer metrics mentioned diversity in 2022 compared to the year before.

This doesn't necessarily mean companies are less committed to improving diversity, but the way these goals are articulated may have changed, said **Susan Mac Cormac**, a partner with **Morrison Forrester** who co-chairs the firm's ESG practice.

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Outside human capital, other goals are more industry-specific. Metrics related to greenhouse gas emissions, for example, can be found in the annual executive plans of companies like **Chevron** and **Exxon Mobil**, which are in the business of mining and extraction. These same companies are less likely to include metrics related to customer satisfaction or cybersecurity.

Mac Cormac said she's noticed the strongest growth in environmental metrics, as companies try to encourage long-term emissions reduction by breaking it up into smaller goals.

"You have goals on an annualized basis because you're not going to be able to do it overnight," Mac Cormac said. "A lot of the stuff that has to be done is difficult and requires fundamentally changing operations."

She added that the recent SEC climate rule is light enough that it likely won't directly factor into compensation plans. Instead, companies are adding these metrics voluntarily, which suggests more are identifying sustainability as a key area for improvement.

Making Nonfinancial Metrics Work for You

Once a company has landed on a strategic goal it wants to prioritize, the next step is determining how to measure it.

Gillian Emmet Moldowan, a partner in **Shearman & Sterling**'s compensation and governance practice, suggested that comp committees refrain from being overly prescriptive, as this could stifle creative problem-solving.

"If you create a metric that presupposes only way one of getting to your goal, you might be driving people toward trying to achieve that, but there may have been other ways," said Moldowan.

This is why financial goals have long been a mainstay of annual incentive plans. The goal — making more money — is simple, but the means of achieving it can vary. Maintaining a similar outlook when crafting nonfinancial metrics can be helpful, Moldowan added.

Sometimes a number makes sense from the start, but in other situations, Moldowan said, it's better to begin with a qualitative goal. This goal can then be revisited in future years once the company has a stronger sense of what it's hoping to accomplish and what data could be used to measure progress fairly.

From the shareholder's perspective, it can raise concerns when a nonfinancial metric is not measurable and performance is subjective — especially if the company also doesn't provide a written narrative explaining their decision-making process.

"Even when it's measurable though, there's always a concern," said Vu.

Any metric that creates a disconnect between shareholder returns and executive compensation will be placed under scrutiny, she added. If financial performance is poor yet an executive still manages to meet the target, that could be a sign that annual bonuses aren't properly grading executive performance, Vu said.

Some shareholders feel that nonfinancial metrics don't belong in annual incentive plans at all because too many metrics can muddy the water. Another side, Vu said, believes ESG should be a part of more incentive programs.

Glass Lewis holds the stance that companies know best which metrics to include. All the proxy advisor asks, Vu said, is that the company provide a rationale for each metric.

"It is the responsibility of the compensation committee to account for all those things that might have gotten in the way of a clear reading of how the executives performed," Vu said.