Nonfinancial Metrics

Compensation Committees Should Consider ESG From Three Angles

By Todd Sirras

The evolving role of the compensation committee is a critical element of how companies react to the changing paradigm of corporate governance and value creation. While pay programs, performance measurement, and talent management remain the bedrock of the committee's charter, the committee is becoming a focal point for shareholders to engage on environmental, social, and governance (ESG) issues.

"How do we bring ESG into incentive programs?" is a common question in today's boardrooms. The approach is no different than what's used to make any potential changes to incentive programs. We simply are tasked with broadening the lens of potential solutions to shift away from pure financial results (the "what") and focusing also on the impact of these results for a broader set of stakeholders (the "how"). The starting point for this discussion should be a comprehensive assessment of corporate values and objectives, well before any discussion of pay-related matters. Disclosure and shareholder engagement are two bridges that connect this broader view of strategy and results with pay.

Compensation committees that want to promote nonfinancial aspects of corporate performance should take the initiative to adopt a three-stage framework to deliver rewards that have a more comprehensive assessment of company performance:

1. Establish a strategy and understand the financial implications of meeting goals in the "right" way.
2. Establish expectations with shareholders about nonfinancial activity in pursuit of financial results through ongoing shareholder engagement and broad disclosure in the compensation, discussion, and analysis and 10-K.
3. Promote how stakeholders have been impacted by performance assessments and pay decisions.

Internal conversations about strategy and the resulting financial planning efforts must be broadened to incorporate desired new or additional investment in meeting nonfinancial goals. The board plays a major role in establishing these objectives and holding management accountable for the results. The fear of investor backlash (in the form of lower, short-term share prices) resulting from the potential reduction of short-term growth must be assessed in the context of potential long-term success. While the need to consider links to incentive compensation for management is obvious at this stage, getting there requires delving into how the company tells its story externally to establish and manage shareholder expectations.

Shareholder and investor activity around corporations' societal responsibility is in the early stages of being formalized. Metric frameworks and expected levels of disclosure have been signaled by major institutional shareholders and proxy advisors, and can be seen as sticks (negative consequences) or carrots (opportunities). From a governance perspective, these parameters are (necessarily) all sticks as the investment community publishes its agenda and establishes expectations that are different from the prior regime of promoting financial growth. The carrots are emerging from shareholders in the investment and value creation arena. New investment opportunities exist in the form of stand-alone, socially responsible funds and subsets of existing products. As the broader investing public (i.e., the retail investor) has more opportunities to vote with their wallets, the value ascribed to socially responsible companies is likely to increase. This cannot be understated, because the financial market will evolve to ascribe higher financial value to companies that are pursuing a broader definition of success than pure financial results.

Finally, there's the element of pay. Assessing how the company came to be where it is no longer is a significant factor in most public company pay programs. The direction of pay design has been uniformly evolving toward nondiscretionary models that use upfront financial goals and projections to deliver incentive pay over a one- to three-year time frame. Proxy advisor and institutional shareholder guidelines around pay decisions are, on the surface, oriented toward negative consequences for transgressions.

As corporate goals and objectives evolve away from what is financially measurable, so too must performance assessment and pay decisions. The rigid structures we have in place for delivering incentive pay are not fully suited to a rapidly changing environment, but there is room for discretion in performance assessment—provided that the disclosure and shareholder engagement can be tied back to company values and strategy that have a perspective broader than financial results.

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