PREPARING TO INCORPORATE ESG METRICS IN INCENTIVE PROGRAMS

HUGESSEN CONSULTING

Authors: Emily Parsons and Blake Jackman

In the first article of our ESG series, we explored the rationale and benefits of including ESG in executive compensation. As the inclusion of ESG metrics in incentive plans has become increasingly common, Boards are asking themselves to what degree their company is "ready" to begin including ESG metrics in their compensation programs.

In this article, we introduce one framework that companies can use to identify where they are in their ESG journey and areas for improvement. This assessment can then inform the development of robust, meaningful ESG measures in compensation.

Assessing Your Company's Current State

ESG metrics, like any other incentive metrics, should be rooted in the organization's strategy. It is also critical that management and the Board have the capability to set targets, track performance, and assess outcomes, in the context of a compensation framework that is well-understood and grounded in first principles.

These concepts form the basis of our framework (illustrated below). We view this as a progression, whereby each category supports the development of the following categories.

	Defining Question	*Ideally, this looks like...*
Board Effectiveness & Governance Processes	*Does the Board have the ability to effectively oversee ESG?*	*...the Board has the right people, with the right skills, and appropriate Committee oversight to effectively oversee a robust ESG strategy*
ESG & Corporate Strategy	*Has the company developed a comprehensive ESG strategy?*	*...there is a clear sense of short- and long-term ESG risks and opportunities, informed by a materiality assessment*
Reporting, Forecasting & Analysis	*Are ESG metrics reported, forecasted, and analyzed in an effective manner?*	*...the organization has the ability to measure, forecast, and analyze critical metrics, in order to effectively assess performance*
Compensation Structures	*Are the compensation structures set up to enable the inclusion of ESG metrics?*	*...there is a well-understood compensation philosophy, structure, and annual process, which enables the company to incorporate ESG metrics and set appropriate compensation targets*

Key Assessment Factors

Below we provide examples of key factors that may be included in the current state assessment for each category. These do not constitute requirements for the inclusion of ESG metrics; rather, they inform the complexity of the ESG incentive plan that the company could feasibly implement and manage today.

The "complexity" of a program may refer to the metrics selected, weighting, time horizon, measurement approach, calibration, or applicable scorecard (i.e., corporate vs. business unit vs. individual).

Assess the extent to which…

Board Effectiveness & Governance Processes	*…there is alignment between director's skills and experience and the organization's needs* *…the right committees are in place and work is effectively scoped between committees* *…the Board's focus is appropriately balanced between hindsight, foresight, and oversight*
ESG & Corporate Strategy	*…the company has a clearly defined mission, vision, and long-term corporate strategy* *…the company's corporate and ESG strategies are complementary* *…key ESG priorities have been identified, and are informed by a robust risk/materiality assessment*
Reporting, Forecasting & Analysis	*…there are robust and well-understood data governance processes in place* *…ESG reporting is validated by a third party / auditor* *…ESG metrics are regularly analyzed and forecasted in the short- and long-term*
Compensation Structures	*…the company has developed a comprehensive compensation philosophy* *…there are established processes for setting targets and evaluating performance* *…the company has a long-term performance-conditioned program in place*

Looking Forward

Coming out of this assessment, companies may identify gaps in their current capabilities that they may wish to address to reach their desired future state. As the company evolves in its ESG journey, so too will the incentive programs; revisiting the current state assessment on a regular basis can support this process.

The next article in our series will discuss how companies identify which ESG metrics are appropriate for their incentive programs. To ensure you receive future articles in this series, subscribe here.

Hugessen Consulting is an independent consulting firm dedicated to helping boards make the right decisions within an environment of heightened complexity and scrutiny. With offices in Toronto, Montreal, and Calgary, the firm's mission is to be the leading provider of advice to public and private boards on executive compensation, performance measurement and assessment, board effectiveness, and related governance.