

Harvard Law School Forum on Corporate Governance

ESG Overperformance? Assessing the Use of ESG Targets in Executive Compensation Plans

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While the demand for firms to promote ESG values may be pulling back from its highest peaks, ESG performance still motivates the investment decisions of many institutional investors. One way that these investors can incentivize performance for their portfolio firms is to insist that companies link executive pay to the achievement of favored ESG outcomes. And in recent decades, they have done so. The number of S&P 500 firms that have tied some element of executive compensation to ESG performance has ballooned from about 12% in 2004 to about 63% in 2023.

While this phenomenon has been the subject of much research, we know little about how often executives achieve the ESG goals that are part of their compensation arrangements. This gap in our understanding is due to several factors, which include substantial diversity in the processes used to link ESG outcomes to executive compensation and the unstructured reporting of these awards and their outcomes in companies' proxy statements.

We aim to fill this gap in our new paper "[ESG Overperformance? Assessing the Use of ESG Targets in Executive Performance Plans](#)." Using a mix of hand coding and GPT-aided auditing, we comb through the proxy statements for the S&P 500 during the 2023 proxy season. We determine whether firms use ESG performance targets, how they set those targets, and whether executives meet those targets.

Our findings on whether these firms use these targets tracks the prevalence of ESG performance goals documented in previous research. Of the S&P 500, 315 of them incorporate some type of compensation tied to ESG goals. The vast majority of this compensation is incentivized through the annual bonus, as opposed to salary or long-term equity compensation. More specifically, of the 315 firms, 304 of them incorporate ESG-linked pay through the company's annual bonus plan, while just 49 firms incorporate ESG-linked pay through the long-term equity incentive plan.

We find wide variation in how firms set and measure the ESG performance of their executives. For some, the process is somewhat ad-hoc. The compensation committee meets and assesses how well an executive achieved a loose set of goals. For example, in fiscal year 2022, Satya Nadella, the CEO of Microsoft, received part of his ESG bonus for conducting layoffs with "a focus on dignity and respect for the impacted employees." Other firms set targets that do not provide for compensation committee discretion. These include diversity goals with hard targets and safety goals that depend on the number of incidents reported to government regulators. Perhaps unsurprisingly, we find that executives miss hard targets more than discretionary ones.

We also determine whether executives met or missed both the financial and ESG targets connected to their annual bonuses. Financial targets are nearly always hard targets that are tied to measures such as revenue and profitability. In general, they appear to be set at levels that are not easy to hit, which would explain why executives missed all of their financial targets 22% of the time in our sample. ESG targets, it appears, get set in a different way. We find that, of the 247

firms that disclose an ESG performance incentive, only 6 of them reported missing every target. That is, 98 percent of them met at least one ESG target. Similarly, we find that 44% of firms met or exceeded all of their financial targets while 76% of firms met or exceeded all of their ESG targets.

We ask whether this high rate of ESG achievement is due to excellent ESG performance or whether it is a product of inadequate corporate governance. We cannot, of course, measure the executives' ESG performance directly, but we are able to find some suggestive associations. We first analyze whether meeting or exceeding all ESG goals is associated with an increase in firms' ESG scores. Using three different measures of ESG performance, we find no statistically significant association between attaining ESG performance goals and improvements in ESG scores. We next examine whether there is an association between whether a company meets or exceeds all of its ESG targets and the level of shareholder support that executives receive during the annual say-on-pay vote. Here we do find a statistically significant negative association. This evidence is consistent with the theory that ESG targets are set at levels that reflect weak corporate governance. That is, they may be set at levels that are low to allow executives to reap their rewards even if ESG performance is not particularly strong.

Our findings highlight the potential perils firms face in linking executive pay to ESG outcomes. Motivating better ESG performance benefits from setting award thresholds and the amount of compensation at high levels. But doing so poses the risk that executives will miss the targets, which may indicate to the outside world that managers are not prioritizing ESG values. The evidence we develop in this paper suggests that firms may have responded to this dilemma by setting ESG incentive targets at levels that are designed to be achieved.

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