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FEET TO THE FIRE

HOW SHOULD COMPANIES TIE COMPENSATION TO CLIMATE TARGETS?

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INTRODUCTION

In recent years, many companies have made voluntary pledges to reduce their carbon footprint, in response to pressure from investors, stakeholders, and members of society to combat climate change.¹ According to MSCI, approximately half of large, publicly traded companies have established carbon emissions targets, and a third have pledged to achieve net zero emissions by 2030 or 2050 (see Exhibit 1).²

A promise to reduce emissions, however, does not necessarily mean that targets will be met (see Exhibit 2).³ It is up to institutional investors to evaluate the viability of corporate claims. As outsiders, it is difficult for many investors to gain insight into the programs companies have implemented, the milestones targeted, and the resources and dollar amounts committed. While the sustainability reports voluntarily published by companies disclose data to support some of this analysis, corporate carbon reduction programs are essentially a black box to institutional investors concerned about the economic impact of climate change on their portfolio.⁴

One place where institutional investors should look to evaluate a company's commitment to carbon reduction is the executive compensation plan. In theory, if a company prioritizes an objective—strategic, financial, operational, or otherwise—it will compensate the executive team for pursuing that objective. (As one study of corporate culture succinctly puts it: “People will invariably do what you pay them to do.”⁵)

To this end, more companies in recent years have been tying executive compensation to sustainability goals. According to Willis Towers Watson, over half (56 percent) of companies in the S&P 1500 tie a portion of the annual bonus to one or more ESG metrics, and 8 percent include an ESG metric in the long-term program. The typical weighting for these metrics is less than 20 percent.⁶ Carbon reduction is only a subset of these bonus structures. A separate study by the same consultancy finds that only 12 percent of the S&P 500 include climate or environmental measures in the annual bonus, and 2 percent in the long-term

bonus. Oil and gas companies and public utilities are (by far) most likely to include environmental targets in their compensation programs (see Exhibit 3).⁷

In addition to deciding whether to include a metric, companies have a choice of how to structure the metrics. Options include:

- **Discrete weighting.** A specific percentage of the bonus is awarded (or withheld) based on the achievement of a quantitative metric.
- **Scorecard.** A specific percentage is awarded based on the achievement of a mix of quantitative and qualitative metrics.
- **Modifier.** The overall bonus earned based on primary metrics (generally financial performance) is adjusted up or down within a specified range based on the level of achievement of the modifier goal.
- **Discretionary.** The board determines at its own discretion whether a bonus payment is merited.⁸

Generally speaking, assigning a discrete weighting to a performance metrics creates the strongest incentive to achieve a goal, while a discretionary bonus structure is the weakest. According to Semler Brossy, scorecards are the most prevalent method of incorporating ESG metrics in annual bonuses (used 40 percent of the time that ESG goals are adopted), followed by discrete weightings (26 percent), discretionary (21 percent), and modifiers (14 percent).⁹

The effectiveness of using executive compensation to encourage climate or sustainability goals is largely supported by the research literature. Hazarikina, Kashikar, Peng, Röell, and Shen (2022) find that companies that adopt ESG metrics in executive pay plans exhibit both higher ESG scores and profitability.¹⁰ Cohen, Kadach, Ormazabal, and Reichelstein (2023) find that companies that link pay to climate objectives subsequently realize a decrease in emissions. The authors do not find an impact on operating performance or share price.¹¹ Desai, Lam, Li, and Rajgopal (2023) find that shareholders react negatively to the adoption of carbon reduction targets by a sample of oil and gas companies, but the

reaction is less negative when targets are incorporated in executive pay contracts.¹² On the other hand, Bebchuk and Tallarita (2022) caution that the inclusion of ESG metrics in compensation plans can harm shareholder and stakeholder outcomes by introducing a dual-mandate that allows management to sidestep accountability to either objective. The authors note this risk can be lessened through the use of clear, objective, and standardized metrics.¹³

Walker (2022) argues that nondiscretionary ESG incentives—as currently structured—are too insignificant to materially influence behavior. Using a sample of companies committed to improving stakeholder outcomes, he calculates that incentive compensation linked to those goals represents, on average, only 1.1 percent (0.2 percent median) of total compensation.¹⁴

In this Closer Look, we examine how some companies institutionalize their climate commitments through executive compensation contracts. We find considerable variation in the choices they make, the structure of their programs, method of implementation, and ongoing support at the board and executive levels. Based on these learnings, we identify best practices for companies serious about demonstrating their commitment to climate objectives to shareholders.

CLIMATE AS A COMPENSATION METRIC

In fall 2023, we interviewed the chief sustainability officer and senior executives at seven world-class companies with highly recognizable name brands in technology, consumer, and industrial sectors.¹⁵ These executives spoke candidly about the evolution of their programs, the decision to include climate targets in compensation, their rationale for design and measurement choices, and the impact and their learnings from these efforts.

While from an external perspective the decision to implement a carbon reduction program might seem straightforward, the experiences of these companies demonstrate that companies approach sustainability from very different starting points and have different stories to tell about how their programs are launched, accepted, institutionalized, refined, and supported.

Impetus and motivation. There is no single genesis for a carbon reduction program or the decision to include climate-related targets in the incentive compensation system. In some cases, the CEO, board member, or founding shareholder is convinced of the environmental importance of institutionalizing climate goals. These individuals recognize their position of authority and, as leaders, want to embed climate objectives into the “DNA” of the company during their tenure (and beyond).

In other cases, the company’s strategy or the prominence

of its brand compels the organization to consider the impact that environmental issues have on its business—its customers, suppliers, communities in which it operates, etc. Through a lens of sustainability, the company assesses the financial and reputational risk of a variety of environmental factors. Climate change is generally one of these. Others might include recyclability of materials, plastic reduction, water usage and waste water, biodiversity, pollution, or chemical byproducts. The company prioritizes the factors that pose the largest risk to the business and its stakeholders.¹⁶

In both situations, compensation is viewed as a central means of signaling the importance of climate objectives and holding executives accountable for achieving them.

Plan design and participants. Consistent with the data presented earlier, many more companies that we interviewed include climate objectives in the annual bonus program than the long-term incentive program (LTIP). They structure their programs in a variety of ways: discrete weighting, a modifier (contingent upon hitting financial targets), or a scorecard. Some originally began with a discretionary award and moved toward rigorous targets as the program matures and there is more buy in from employees.

A common theme is the importance of simplicity: selecting a structure by which they clearly articulate to employees the link between pay and performance goals. If the employees do not easily see the linkage between climate targets and compensation, the plan is likely not to succeed.

Another common theme is that the weighting assigned to climate metrics (either specifically or within an environmental scorecard) has increased over time. One company originally assigned a 5 percent weighting, subsequently increased 20 percent.

While more companies use the annual bonus to institutionalize climate objectives, there is widespread recognition of the timing mismatch this creates. Because climate initiatives are long-term in nature, it logically makes sense to include them in the LTIP. LTIPs also represent a much larger portion of total compensation than the annual bonus, and so including climate goals in the LTIP gives it much more overall weight.¹⁷

The challenge for many companies is that LTIPs generally includes only 2 or 3 performance targets. Companies that include carbon reduction goals in the LTIP significantly raise the prominence of these goals.

Among the companies we spoke to, climate-linked bonuses are generally offered from senior-most leadership down to plant managers or supply chain managers. In a large multinational

company, this might include several thousand employees. For companies that include climate in the LTIP, the population is smaller—generally the top 300 or 400 executives.

Setting targets and milestones. Two primary considerations in setting climate-related objectives are the achievability of goals and the choice of metrics. Companies recognize a tradeoff between making goals difficult enough to stretch the organization and realistic enough that they can be achieved.

For most companies, the bulk of the effort to date has focused on Scope 1 emissions (directly controlled by the company) and Scope 2 emissions (indirect emissions through purchased electricity, steam, heating and cooling). Scope 3 emissions (those generated by end users, customers, suppliers and partners) are understood to be larger in scale but more difficult to influence, and therefore less of an immediate focus.

Companies adopt a range of metrics, from qualitative to science-based.¹⁸ They also choose whether to adopt net targets (with emissions reduced through offsets) or absolute targets (gross reductions).¹⁹ External firms are used to vet targets and benchmark against peers. Companies are generally willing to discuss targets with their peers.

Long-term objectives are broken down into annual goals. Most companies acknowledge that it takes time to learn how to break down multi-year targets into one-year goals. Through repeated effort, they learn how efficiency programs, sourcing programs, and technology translate into emission reductions. To many, the process is analogous to continuous improvement programs for capital efficiency. It also takes time to get the largest suppliers on board and to educate smaller suppliers on how they can reduce their carbon footprint.

While some companies aim to realize straight-line reductions (for example, 3 percent annual decreases in absolute terms), others are on a “hockey-stick” trajectory. Targets for the first five to seven years focus on the transition to renewable energy and gross energy reductions in production and supply. Beyond this, there is general acknowledgement that technological innovation (outside the company) is going to be required for companies to achieve their long-term pledges. To reduce Scope 3 emissions, companies are considering ways to shift supplier, competitor and customer behavior. Industrial companies—whose end products are direct emitters of greenhouse gasses or, conversely, who provide climate solutions—have more direct control of Scope 3 emissions and invest in technological innovation to reduce the environmental impact of their products. These companies are more easily able to directly link product strategy and climate strategy.

The metrics in the annual compensation program are tied to

one-year objectives and are tailored to the job function and level of authority of the individual. Senior leadership is held responsible for organizational or divisional goals; employees farther down the organization are given metrics that roll up in support of these. Supply chain and production managers have very different climate goals than other sales or support functions. For many companies, climate is one of a handful of key environmental metrics included in an overall sustainability scorecard. The objective in goal setting is to establish a glidepath where by annual reductions lead to the achievement of long-term goals. Companies struggle with the real possibility of how to adapt if annual targets are missed, putting long-term goals at risk. Companies recognize both the risk and damage that might occur if long-term targets are missed. They also recognize this possibility, given the long-term nature of the goal and the assumptions to achieve outer-year targets.

Implementation and buy in. Companies express very different experiences in the implementation of programs and creating buy in. For most, adopting climate targets and tying these to compensation is a multi-year (even decade-long) process. Companies newer to the effort will be faced with shorter timelines but have the benefit of learning from those who have gone before them.

Companies phase the implementation, first adopting metrics to test their use and calculation before tying metrics to compensation. They also start at the top, adding climate goals to senior executive bonuses before rolling out to larger populations.

Organizational resistance to these efforts tends to center less on the need to address climate change than on the practicality of tying pay to climate. Examples of organizational resistance include board members concerned about the cost of initiatives (one company referred to this as “stealing from shareholders”), senior executives split on whether climate is a win-win or costly, engineers focused on product quality (the carbon footprint of product development is a lower priority and can be seen as increasing product cost), and marketers trained not to take into account self-reported factors that customers say drive their purchase decisions (customers might say they will pay more for an environmentally friendly product when in reality they will not). Some companies observe generational differences, with older and younger demographics split on their readiness to accept goals. Companies that experience financial difficulty are less likely to prioritize climate objectives when the core business is struggling.

Companies report that incremental commitments help to institutionalize the program. Framing the importance of climate objectives can drive engagement among production workers in a way that is more meaningful than emphasizing efficiency goals.

Tracking and reporting. Companies describe modest investment to develop systems to track climate data. Existing supply chain and financial systems usually are not designed to include this information and so early efforts require manual data collection. Over time, however, companies invest in system to collect raw data and perform calculations. These processes are separated, with business units reporting the raw data and a centralized group (usually under the control of a small number of individuals reporting to the sustainability officer) making the calculations. This separation improves the integrity of reporting. When errors occur, they are generally due to inadvertent inaccuracy rather than fraud or misrepresentation. Tracking reports are distributed to vice presidents who distribute the results within their functional group. Most companies see auditing as critical to ensuring the reliability of data. An audit of climate metrics forces the company to think rigorously about how to measure climate performance and, in the words of one company, “makes the results indisputable.”

Organizational oversight. Climate tracking and reporting ultimately rolls up to the board. The companies we spoke with all indicate high board engagement across multiple committees. The full board considers sustainability within the broad context of ESG and strategy. Performance is tracked by the corporate responsibility committee, technology committee (to the extent internal innovation is required to achieve goals), as well as the compensation, governance, and audit committees. The board considers the rigor of goals, whether climate goals are a distraction to other business objectives, the operating and investment requirements to achieve climate targets, progress, and results.

Most companies state that their boards are currently wrestling with such issues as whether to include climate or environmental goals in the LTIP and whether and how to move to science-based targets.

The response of stakeholders to corporate efforts is generally positive. Employees are proud to know that the company they work for prioritizes decarbonization. Suppliers understand the business imperative of supporting climate efforts. Institutional investors with an ESG mandate embrace the institutionalization of carbon reduction programs and reinforcing these through compensation. The broader investment community appreciates sustainability efforts as de-risking the company (creating a clean public profile). Local communities and customer groups see environmental abatement efforts as necessary for companies to maintain their social license to operate.

Most companies have considered the legal risk that might arise from not achieving their stated objectives. They recognize

the possibility of this occurring but are not sure what the legal, reputational, or financial risks might be.

RECOMMENDATIONS

Based on our interviews, we recommend the following practices for developing a climate program and integrating it into the compensation program:

Leadership and organizational commitment. A company’s commitment to decarbonization is most effective when leadership (CEO, senior executive team, and board) genuinely embraces climate goals. This includes prioritizing decarbonization so it is not seen as secondary to strategic and financial objectives but integral to them. Climate-related goals are tied to strategy, embedded in budgets, and ultimately made part of culture. The reasons that the organization has committed to climate goals should be clearly and consistently articulated to divisional leaders and within functional groups to overcome resistance, remove inertia, and convince employees of the financial, organizational, and environmental necessity of decarbonization.

Metrics and reporting. Climate objectives should be few in number, low in redundancy, and largely quantifiable. We found that the most successful companies adopt science-based targets because of their demonstrable link to net-zero emission goals. Long-term targets are broken down into clearly achievable milestones, which map to quarterly, annual, and multi-year budgets and are supported by granular plans for capital allocation and procurement. Companies should be prepared to invest up front in systems for raw data collection and analytical processes, and entrust the reporting process to a small team of experts to ensure consistency and accuracy. Continuous improvement generally decreases cost and increase reliability over time. Ultimately, reported metrics should be audited to ensure accuracy and reliability.

Compensation. Climate programs are most effective when goals are added to executive and senior-manager compensation contracts to fully align the organization with its commitments. While many companies use the annual bonus program to do so, the most successful companies also embed climate in the long-term incentive program (LTIP) to match the timing of goals and compensation payouts. Annual targets in support of long-term goals are then reinforced through the annual incentive program. The achievement of annual goals gives executives and employees confidence that long-term objectives will be met. The rewards for meeting climate pledges should constitute a material part of at-risk compensation to encourage performance. Transparent reporting of interim and long-term targets allows the board

and shareholders to monitor progress and hold the company accountable.

WHY THIS MATTERS

1. In recent years, hundreds of companies have made public commitments to achieve net-zero emissions by 2030 or 2050. What investment have these companies made—in efficiency programs, supply chain, innovation, and technology—to achieve these goals? To what extent have carbon reduction initiatives been fully integrated into strategy, business model, and operations? How realistic are the assumptions that underlie corporate projections for carbon reduction?
2. Ultimately, any company that is committed to achieving an objective will provide executives with a monetary incentive to achieve that goal. Industry data, however, indicates that only a minority of companies include climate metrics in their annual bonus programs, and even fewer in the long-term program. Why? What are the internal impediments that prevent more from doing so? Can a company that does not include climate metrics in its incentive plans really be “serious” about its commitment to carbon reduction?
3. Interviews with senior executives reveal significant variation in the structure and implementation of climate programs. These differences manifest themselves in the rigor of targets; investment in data and analytical systems; the integration of goals with planning, budgeting, and procurement; financial incentives for results; and ongoing prioritization and support from senior executives and the board. What accounts for these differences? Do industry and market pressures cause some companies to be more proactive about implementing these programs? Or is it driven largely by differences in personal commitment by the CEO, board, or founding family?
4. Institutional investors bear the financial consequences of a company’s ultimate success or failure in addressing sustainability issues. How can outside investors determine whether a company will meet its objectives? What are the legal, regulatory, and financial consequences of missing them? Does the adoption of science-based targets, supported by rigorous data collection, transparent reporting, linked to short- and long-term executive compensation lessen this risk? ■

reduction” rather than the broader label of greenhouse gas emissions that include other emissions, such as methane. Data from MSCI, “MSCI Net Zero Tracker,” (July 2023).

- ³ According to RepRisk, approximately one out of four U.S. and European companies do not achieve or overstate their environmental efforts. The legal risk of so-called “greenwashing” is unknown at present, but it is likely not insignificant. Gartner estimates that by 2026, as many as 80 percent of global companies with net zero goals will have to restate their interim milestones because of an inability to meet them. See Peter Pears and Tim Baines, “Greenwashing: Navigating the Risk,” *Harvard Law School Forum on Corporate Governance* (June 24, 2023), available at: <https://corpgov.law.harvard.edu/2023/07/24/greenwashing-navigating-the-risk/>.
- ⁴ Climate disclosure rules proposed by the Securities and Exchange Commission would standardize certain disclosure and incorporate it in the audited financials. However, it is not clear that investors would have access to materially different information.
- ⁵ Research participant cited in John R. Graham, Campbell R. Harvey, Jillian Popadak, and Shiva Rajgopal, “Corporate Culture: Evidence from the Field,” *Social Science Research Network* (2016).
- ⁶ Neanda Salvaterra, “Companies are Increasingly Linking CEO Bonus Payouts to ESG Goals,” *Agenda* (June 16, 2023).
- ⁷ This study also finds that European companies are twice as likely as U.S. companies to include climate metrics in bonus programs, although the industry mix of European versus U.S. companies muddies the comparison. See Willis Towers Watson, “Executive Compensation Guidebook for Climate Transition,” 2021.
- ⁸ Semler Brossy, “ESG + Incentives, 2023 Report,” (2023).
- ⁹ Note, these percentages are for ESG metrics as a whole and are not necessarily specific to environmental/climate goals. Sample includes S&P 500 companies. Ibid.
- ¹⁰ Sonali Hazarika, Aditya Kashikar, Lin Peng, Ailsa Röell and Yao Shen, “ESG-linked Pay Around the World—Trends, Determinants, and Outcomes,” *Social Science Research Network* (2022), available at: <https://ssrn.com/abstract=4410068>.
- ¹¹ Shira Cohen, Igor Kadach, Gaizka Ormazabal, and Stefan Reichelstein, “Executive Compensation Tied to ESG Performance: International Evidence,” *Journal of Accounting Research* (2023).
- ¹² Hemang Desai, Pauline Lam, Bin Li, and Shiva Rajgopal, “An Analysis of Carbon Reduction Pledges of the U.S. Oil and Gas Companies,” *Management Science* (forthcoming), available at: <https://ssrn.com/abstract=4300455>.
- ¹³ Lucian A. Bebchuk and Roberto Tallarita, “The Perils and Questionable Promise of ESG-Based Compensation,” *The Journal of Corporation Law* (2022).
- ¹⁴ David I. Walker, “The Economic (In) Significance of Executive Pay ESG Incentives,” *Stanford Journal of Law, Business & Business* (2022).
- ¹⁵ Because of the proprietary nature of the information, the names of these companies and the executives we spoke with are kept confidential. The sample includes both private and public companies.
- ¹⁶ Companies are also aware that many customers and employees (both current and prospective) consider environmental sustainability an important criterion for the products they buy or the company they work for, and credible programs can differentiate the company from its competitors.
- ¹⁷ On average, two-thirds of the total compensation granted to CEOs is in the form of equity-linked awards, compared to only a quarter through the annual bonus. See David F. Larcker and Brian Tayan, “CEO Compensation: Data,” Stanford Quick Guide Series, Research

¹ This Closer Look is published in conjunction with a report on the same subject published by Galvanize Climate Solutions and Stanford University, titled “The Missing Link: Aligning Executive Compensation with Climate Action,” (2023), available at: <https://galvanizeclimate.com/>.

² For simplicity of discussion, we refer to climate efforts as “carbon

Spotlight (2023), available at: <https://www.gsb.stanford.edu/faculty-research/publications/ceo-compensation-data>.

¹⁸ Science-based targets are those that provide a direct path to reducing emissions in line with the Paris Agreement goals. These goals are published by the Science Based Targets initiative (SBTi). See <https://sciencebasedtargets.org/how-it-works>.

¹⁹ Environmental offsets are actions or investments that a company makes to compensate for the carbon dioxide (or other environmental impact) generated by its activities. For a discussion of environmental offsets, see Absorbtech, “What Does Offsetting Mean?,” available at: <https://absortech.com/moisture-magazine/what-does-offsetting-mean/>.

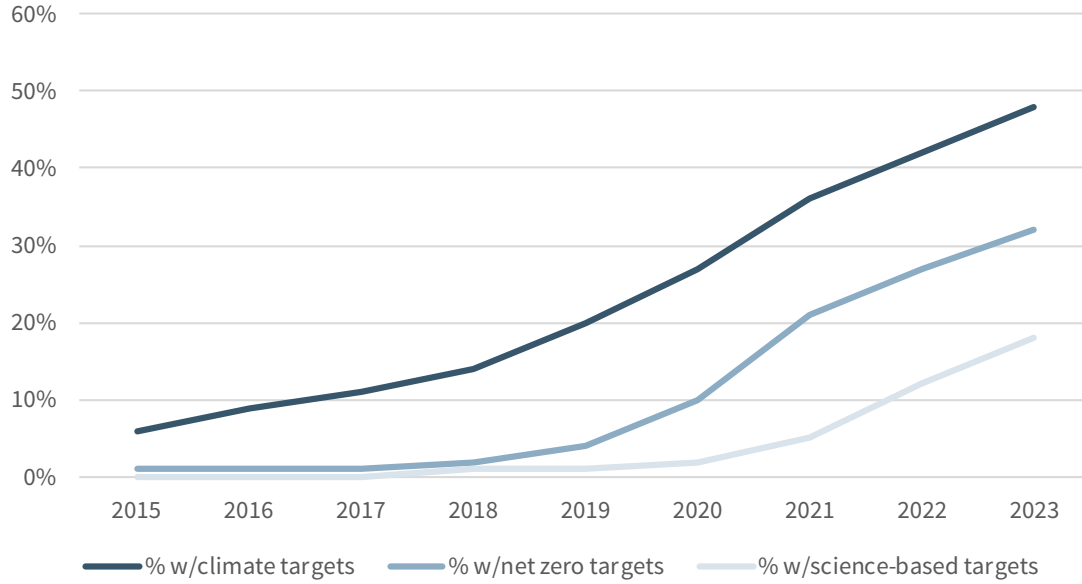
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The Stanford Closer Look Series is dedicated to the memory of our colleague Nicholas Donatiello and to the retirement of our colleague Michelle E. Gutman.

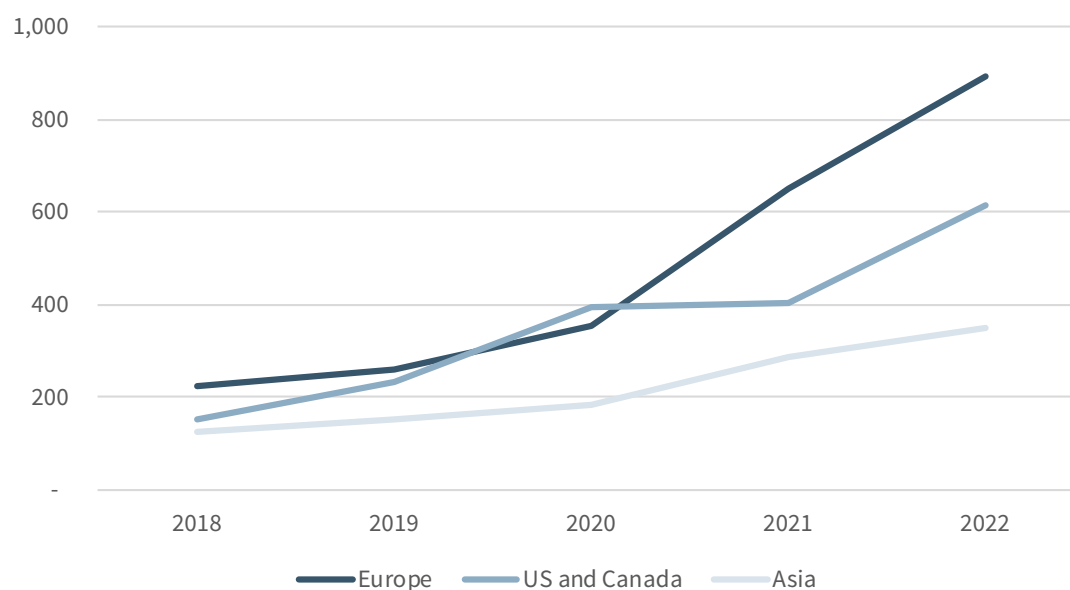
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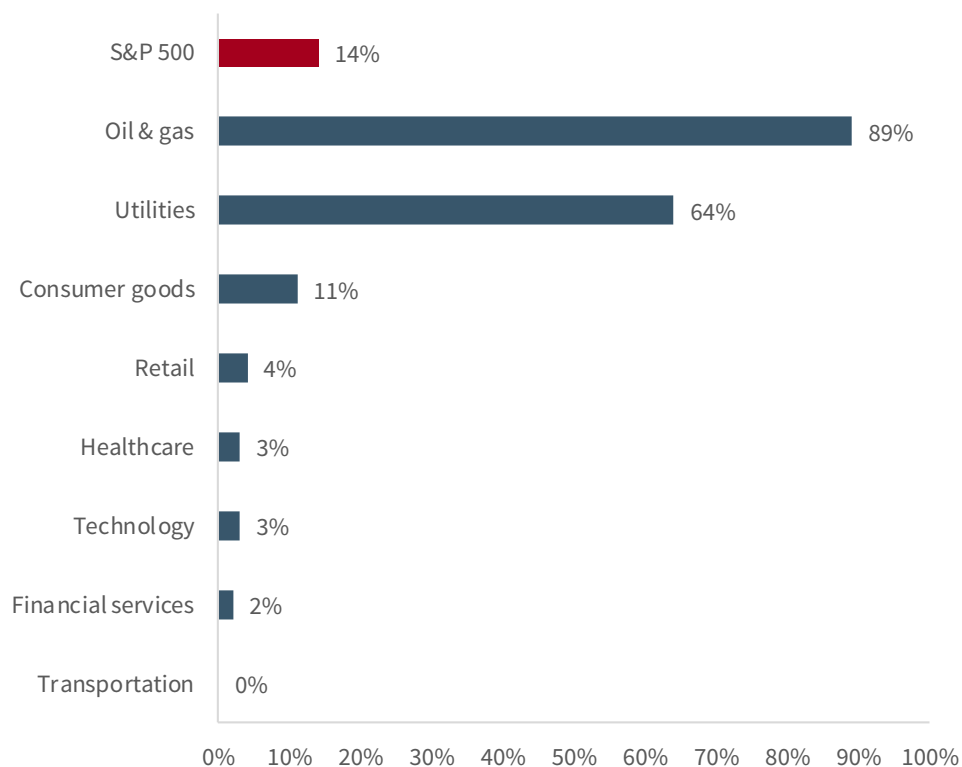
EXHIBIT 1 — PERCENT OF COMPANIES ESTABLISHING CLIMATE TARGETS



Source: MSCI, "MSCI Net Zero Tracker," (July 2023).

EXHIBIT 2 — INCIDENTS OF GREENWASHING AMONG COMPANIES, BY CONTINENT OF HEADQUARTERS

Source: RepRisk, “On the Rise: Navigating the Wave of Greenwashing and Social Washing,” (October 2023), available at: <https://www.reprisk.com/news-research/reports/on-the-rise-navigating-the-wave-of-greenwashing-and-social-washing/20adb3d8>.

EXHIBIT 3 — USE OF CLIMATE AND ENVIRONMENTAL METRICS IN EXECUTIVE COMPENSATION PROGRAMS

Source: Willis Towers Watson, "Executive Compensation Guidebook for Climate Transition," (2021).