Telling the Story

The proliferating use of ESG and other nonfinancial performance metrics

By Ron Schneider

DFIN

Having an effective and credible environmental, social and governance (ESG) story has moved past the "nice-to-have" stage and has arguably become a near necessity. Companies lagging their peers in this area increasingly face a wealth of challenges, from finding themselves subject to intense engagement focus by a growing range of investors to being penalized through lower demand for their stock and higher costs of capital—as well as becoming easy targets for activists.

Clients have often cited two main obstacles to commencing their ESG and disclosure journeys:

- Lack of harmonization between competing and seemingly conflicting materiality and reporting standards

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Figure 1
The ODP Corporation (formerly Office Depot, Inc.) proxy filed March 17, 2022, page 47.
See full proxy statement at ***bit.ly/3L9GpZq***.

The table below summarizes the metrics for the 2021 Annual Bonus Plan.

2021 Company Metrics*	Weight	Threshold Parameter (50% Payout)	Target Parameter (100% Payout)	Maximum Parameter (200% Payout)
Adjusted EBITDA	40%	$404.6 million	$476 million	$547.4 million
Net Sales	40%	$8.895 billion	$9.36 billion	$9.83 billion
Non-Financial ESG	20%	N/A	N/A	N/A

* Adjusted EBITDA and Net Sales are non-GAAP financial measures. For purposes of our 2021 Annual Bonus Plan, we used Adjusted EBITDA and Sales as reported in our fourth quarter fiscal 2021 earnings press release included as an exhibit to our Current Report on Form 8-K furnished on February 23, 2022 and adjusted them in accordance with the categories of excluded items previously noted.

Non-Financial Strategic ESG Metric

Based on our shareholder outreach, we heard from investors that they wanted to see our executive compensation tied to progress on key non-financial strategic ESG goals. As a result, the C&T Committee approved the inclusion of certain ESG initiatives to make up 20% of the Annual Bonus Plan for 2021. The table below summarizes the ESG Initiatives and the strategic measures that were assessed by the C&T Committee at the end of fiscal year 2021 to determine the achievement of these initiatives.

Weighting (of 20%)	ESG Initiative	Strategic Measure
30%	Environmental	Increase waste diverted from landfills by over 50% by the end of 2021 through increased recycling, materials reduction and waste reduction.
40%	Social	Launch, support and expand Elevate Together in 2021 with success to be measured against the completion of a set of pre-established milestones.
30%	Governance	Identify and adopt relevant disclosure standards promulgated by the Sustainability Accounting Standards Board (SASB)* for measurement and use in the Company's annual report or other public disclosures beginning in 2022.

* SASB and the International Integrated Reporting Council (IIRC) announced that they will merge to create the Value Reporting Foundation.

As described in the Annual Bonus Plan, the C&T Committee has the authority to make adjustments to ensure that compensation appropriately reflects operating performance that is reasonably within management's control. CompuCom was placed into discontinued operations for the third and fourth quarters of 2021. The 2021 Annual Bonus Plan Results table below summarizes the final performance of the 2021 Annual Bonus Plan, excluding the target and actual Q3/Q4 2021 performance for CompuCom.

For purposes of determining the level of achievement for each of the bonus metrics under the Annual Bonus Plan, the C&T Committee reviewed the applicable financial metrics, as derived from our 2021 audited financial statements approved by the Audit Committee. For fiscal year 2021, the C&T Committee certified achievement of the Adjusted EBITDA and Net Sales performance results as reflected in the following table.

The C&T Committee determined that each of the Non-Financial ESG goals were exceeded. In particular, the company increased diversion of waste by more than 3 times the amount necessary to achieve the 50% goal; reaching a 63% diversion rate as of November 2021 (Environmental), achieved all of its milestones in launching, supporting, and expanding Elevate Together in 2021 (Social), and has adopted relevant disclosure standards promulgated by the SASB for Multiline and Specialty Retailers & Distributors and will issue the Corporate Sustainability Report with disclosure aligned to these standards by July, 2022 (Governance). The C&T Committee certified achievement of the Non-Financial ESG metric at 145%.

In reviewing the Adjusted EBITDA, Net Sales and Non-Financial ESG performance results for purposes of determining final payouts, the C&T Committee authorized bonuses to our NEO's under the 2021 Annual Bonus Plan to be paid out at 142.3% of target.

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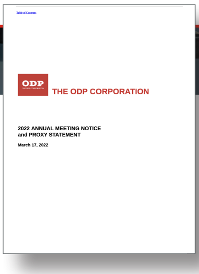


- Uncertainty about the direction of long-anticipated SEC rulemaking

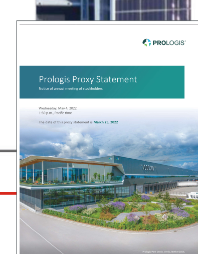
The past year has seen significant movement toward consolidation or harmonization of the reporting standards (with more changes certain to come). In addition, in March 2022, the SEC released proposed rules about climate-related disclosures, eliminating some of the uncertainty about the direction regulators plan to take.

Companies are responding to this clearer ESG landscape by issuing more inaugural and follow-on ESG and sustainability reports and by discussing these topics in traditional financial reports (including proxies and 10-K/annual reports), as well. Cutting-edge reports are increasingly aligned with the leading reporting

Figure 2
Prologis, Inc. proxy filed March 25, 2022, page 43. See full proxy statement at ***bit.ly/3MhyPfy***.

QUANTITATIVE ESG BONUS METRICS IN OUR 2022 BONUS SCORECARD (10% WEIGHTING OVERALL)

	Performance Metric	Target Performance	Submetric Weighting	Rationale for Metric
ENVIRONMENTAL	Solar Megawatts (MW) installed	350MW installed in 2022 (22% year over year increase)	20%	Advances our solar program as a customer-centric energy solution and ancillary revenue source.
ENVIRONMENTAL	Percentage of LED lighting installed across our entire owned and managed portfolio (by area)	67% of O&M portfolio using LED (10% more than year-end 2021)	10%	Advances our LED lighting program as a customer energy solution and is critical to achieving our Science-Based Targets.
ENVIRONMENTAL	Percentage of new developments that are certified sustainable (LEED or equivalent)	95% of new developments certified sustainable	10%	Obtaining third-party verification of our sustainable building practices ensures accountability. The process is also a clear framework for implementing green building features and systematic data collection and meeting our carbon emission and sustainability goals.
SOCIAL	Number of new Community Workforce Initiative (CWI) participants in 2022	5,000 new participants in 2022 (38% growth in overall program)	10%	Encourages continued advancement of our CWI program, which is key to building relationships in the communities in which we develop real estate.
SOCIAL	Culture & Talent Composite Score (includes the same components as 2021 Culture & Talent Composite Score, including Inclusion & Diversity, employee retention and engagement metrics—see page 61)	70% composite score	20%	We seek to foster an inclusive, diverse culture to attract, retain and develop talent. We believe that diversity in thought, background and experience drives innovation and performance.
SOCIAL	IMPACT volunteer hours	10,000 volunteer hours in 2022 (36% year over year increase)	10%	Volunteerism advances a culture of community service that is important to current and prospective talent and strengthens our presence in the communities in which we operate.
GOVERNANCE	Composite corporate governance score across third-party ESG assessments	Combination of Sustainalytics, MSCI, and GRESB scores	20% total (6.666% per score)	We have strong policies in place that ensure responsible governance in furtherance of our stockholders' best interests. Attaching measurable third-party assessments enhances accountability for our already robust governance policies.



standards, such as SASB, TCFD, GRI and the GHG protocol. That said, even as companies are upping their game, investors have a seemingly insatiable demand for more and higher-quality reporting.

As part of this disclosure trend, companies are discussing their material ESG risks and opportunities, with many publicizing their goals or targets for the future. ESG elements have now become part of the overall corporate strategy and increasingly are reflected in compensation program incentives and metrics.

Particularly for newly adopted pay elements—as with other parts of compensation storytelling—it is important to go beyond the "what" and also explain the "why" of your company's actions. Some companies are distinguishing themselves by how clearly and visibly they highlight these new compensation metrics and their rationale

Figure 3
Verizon Communications proxy filed March 28, 2022, page 29. See full proxy statement at ***bit.ly/3vxfwbg***.

Verizon 2022 Proxy Statement

Proxy summary | Governance | **Executive compensation** | Audit matters | Stock ownership | Shareholder proposals | Additional information

Why these performance measures?

For the Verizon corporate performance measures, the Committee selected adjusted operating income, service and other revenue, and cash flow from operations to reflect Verizon's strategic goals of encouraging profitable operations, growth and delivering best-in-class network experiences in a cost efficient manner. Consistent with prior years, the Committee also selected diversity and sustainability metrics to reflect Verizon's commitments to promoting diversity among our employees and our business partners and reducing the environmental impact of our operations.

- **Adjusted operating income** is a measure that reflects operating profitability because it indicates how much profit we generate after subtracting operating expenses, including depreciation and amortization and the other costs of running the business, from total revenue. The Committee views this as an important indicator of how well our management is growing revenue while managing operating costs. Adjusted operating income excludes the effect of special items, which provides more comparable financial results from period to period.
- **Service and other revenue** is a measure that reflects the extent to which we have been successful in attracting and retaining customers, penetrating key markets with our products and services and creating high-quality growth. The Committee views this measure as an important indicator of Verizon's growth and success in realizing its strategic initiatives. The Committee selected this measure for the 2021 Short-Term Plan, rather than total revenue, which was utilized as a performance measure for the 2020 Short-Term Plan, because service and other revenue better reflects our generation of profitable revenue from attracting and retaining customers and penetrating key markets with our products and services and excludes revenue from the sale of equipment, which is generally not reflective of the profitability of our business, is driven by external factors and is not core to the strength of our business.
- **Cash flow from operations** is a measure of the cash generated from our ongoing, regular business activities and is used to fund expansion and modernization of our networks, service and repay external financing, pay dividends and invest in new businesses and spectrum. The Committee selected this measure for the 2021 Short-Term Plan, rather than free cash flow, which was utilized as a performance measure for the 2020 Short-Term Plan, because cash flow from operations is not reduced by capital expenditures. In making this selection, the Committee considered the Company's strategic imperative to quickly deploy the C-Band spectrum it was acquiring in 2021 and determined that this measure would be better aligned with and further the Company's strategy, because it would not disincentivize management from making additional capital expenditures to more quickly put the C-Band spectrum into service, if a faster roll-out could be achieved.
- **ESG metrics** relating to diversity and sustainability reinforce our corporate purpose to "create the networks that move the world forward." As a large, multinational company with a highly diverse customer and employee base, we know that our operations are

For the unit-level performance measures, in addition to the Verizon corporate
the award opportunity for unit leaders, the Committee selected unit-level adju
revenue for the Consumer Group and Business Group and a network expense
further focus the unit-level leaders on driving their individual unit's contribution
The Committee also selected qualitative leading indicators for the Consumer G
leaders on annual strategic initiatives designed around the 5G strategy and oth
long-term growth and, for the GN&T Group, to focus GN&T leaders on maintain
future. At the end of the year, the CEO assesses the extent to which each unit h
make a recommendation to the Committee on the level of attainment.

ESG metrics relating to diversity and sustainability reinforce our corporate purpose to "create the networks that move the world forward." As a large, multinational company with a highly diverse customer and employee base, we know that our operations are strengthened when we leverage the diversity of thought and cultures of our workforce and business partners. We are also committed to reducing the environmental impact of our operations because we believe that it is important for us to be good stewards of our planet while we continue to serve our customers. Therefore, the Committee utilizes diversity and sustainability metrics and targets that measure the percentage of our U.S.-based workforce that is comprised of women and minorities (**workforce diversity**), the amount of our overall annual supplier spend with diverse firms (**diverse supplier spend**) and the percentage by which we reduce our carbon intensity – the amount of carbon our business emits divided by the terabytes of data we transport over our networks – as compared to the prior year (**carbon intensity reduction**).

for adopting them. One payoff from a clearly articulated approach is that investors who understand a company's rationale for its pay plans are more likely to support that company even in the face of negative proxy advisor Say on Pay and similar vote recommendations.

While compiling what will be the 10th anniversary edition of DFIN's *Guide to Effective Proxies*, we have located many stand-out examples of ESG and other nonfinancial performance metrics from a range of companies and industries. Specifics will be featured in the final guide when it is released in September. A few select examples are shown here, including Verizon Communications' proxy (Figure 3), which is a favorite because of its effective "callout" approach. CS

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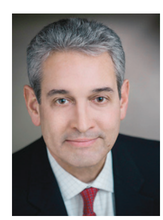
These, as well as many additional examples of impactful disclosure, can be found in DFIN's Guide to Effective Proxies, 10th anniversary edition, scheduled for release in September 2022. Learn more at ***dfinsolutions.com****.*



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