Non-Financial Performance Measures in Executive Compensation

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Arguably, the use of non-financial performance measures in executive compensation is effective and beneficial to the firm when done properly. The firm may be motivated to implement such a practice from both internal and external sources. If the change is made to executive compensation measures, there are many benefits it may provide to the firm as well as drawbacks. The firm may be disinclined from such a method of determining executive pay if they will not gain the desired benefits if a clear plan is not in place or if there is stakeholder pressure to not make the changes. These drawbacks and limitations may be avoided with time and resources being invested into the design of the framework for executive pay.

I. Motivators

A. Long-term performance

Firms who engage in activities to improve their environmental and social impacts will also experience better long-term performance in all aspects including market and financial performance (Eccles et al. 2014)

By incorporating non-financial performance measures into executive compensation, the actions of managers are better aligned with improving long-term firm value (Gan et al. 2020) – it is best when combined with equity-based compensation. This is because in terms of long-term financial performance, nonfinancial measures are better indicators than financial measures (Banker et al. 2000). Therefore, managers are provided with different motivations that refocus their actions to better the long-term value of the firm.

Additionally, employees will naturally feel prouder to work for a firm that engages in activities that improve their environmental and social impacts. As a result, employee morale will be boosted. Employees who have higher morale are likely to be more productive and are likely to be more willing to stay in their jobs. Improved productivity and employee retention naturally will result in profit improvements. This effect would be a motivating factor to firms.

B. Competitive Advantage

Firms may feel motivated to integrate non-financial measures into the executive compensation and disclose such performance to gain a competitive advantage, especially when they are stagnant and must gain an edge in their market to stay afloat.

Linking executive pay to non-financial performance measures will encourage the firm to engage in activities to improve these measures. By engaging in such activities such as improving customer experience, social impact and reducing environmental impact, the status and reputation of the firm will naturally increase. The goodwill of the firm will increase along with this. Improvements to their goodwill, increases their level of intangible assets. It was found that firms that have higher levels of intangible assets will gain a competitive advantage in its market (Zabihollah and Tuo 2017). However, it should be noted that these improvements to goodwill can only be recognised in the books when the firm is acquired of merged (Milost 2013).

Competitive advantage can be additionally improved with voluntary disclosure of non-financial performance. According to the voluntary disclosure theory, the reporting and disclosure of non-financial performance measures, the firm can become distinguished from its competitors who are failing to engage in such activities (Lys et al. 2015).

C. Earnings Management

By integrating non-financial measures into executive compensation, managers will have less of an incentive to engage in earnings management activities.

It was found that using both non-financial and financial performance measures to determine executive pay caused a reduction in earnings management activities (Ibrahim & Lloyd 2011). To improve the quality and reliability of reports, and to avoid unfavorable consequences of earnings management, the implementation of non-financial performance measures into compensation would be beneficial.

D. Pressure from External Stakeholders

An increasing number of firms are including non-financial performance measures in their reports and executive pay due to pressures from external stakeholders (Beyoud 2022).

Activists, investors, and other external stakeholders are increasingly analysing and criticizing such measures and how they are being used in the firm. In fact, a quarter of US companies tied some form of ESG (environmental, social or governance) metric in determining executive pay (Beyoud 2022) including, Royal Dutch Shell, Unilever, Alcoa, Intel Corporation, BP and PepsiCo (Aquila et al. 2020). There are two main motivators that arise because of this. Firstly, firms will want to remain favourable in the eyes of their investors, customers and other external stakeholders and may choose to do so due to these pressures. This pressure would be especially strong from activists in terms of the firms environmental and social behaviour. Secondly, firms would want to stay ahead of the curve and partake in the trend before it becomes the norm.

This will allow the firm to gain a competitive edge within their market as they are doing something to contrast them with their competitors.

II. Implications

All the areas discussed above of what motivates a firm to implement non-financial performance measures into their executive compensation are also implications of doing so, apart from the pressures from external stakeholders.

A. Indication of future financial performance

Evidence has suggested that non-financial performance measures provide far better indicators of future financial performance than financial measures (Ittner and Larcker 1998).

To determine executive pay based off non-financial performance indicators, the firm would analyse and record these indicators. This information can then be collected and used by the firm not only in determining executive pay, but also to predict the future financial performance of the business. This information would be incredibly valuable to the firm and its internal stakeholders to make well-informed decisions and to establish realistic goals. Additionally, this information would also be valuable to external stakeholders and especially analysts and

potential investors. If the indicators predict a prosperous future financial performance, the firm will likely attract more investors and in turn, more capital.

B. Indication of intangible assets

Given that intangible assets are non-financial in nature, it follows that the reporting and disclosure of non-financial performance will help the firm to value their intangible assets (Mehta and Madhani 2008).

When the firm collects this information to determine executive pay, they can re-use this pool of information to value their intangible assets. For example, measurements of employee turnover, employee training and employee satisfaction would be useful in determining 'Human Capital' as an intangible asset.

The collection of the non-financial information will be useful in many more ways than just determining executive pay.

C. Links to long-term organisational strategies

The valuation of non-financial performance is an effective method to align employee and executive action with the long-term strategic plan of the business (Kaplan and Norton 1996).

Measurement of executive performance that is at least somewhat based off the non-financial performance of the business will link the short-term actions of executives to the long-term organisational strategies. Due to the nature of financial goals, to achieve these goals only, the firm would only focus on the short-term. This creates a deficiency - the firm would only be achieving short-term goals and not take steps to achieve their longer-term organisational objectives (Kaplan and Norton 1996). Therefore, including non-financial measures in the determination of executive pay would assist in the achievement of the firm's long term financial goals.

D. Compromise broader corporate strategies

It is important that non-financial goals do not conflict with the broader corporate strategy as to not compromise the longevity of the firm and the achievement of goals (Beyoud 2022). A potential unfavorable implication of the implementation of non-financial performance measures into executive pay is that these measures are improved at the expense of financial indicators and the broader goals and strategies. Therefore, a balance in the design of compensation must be found so that executives can meet their goals for non-financial performance indicators whilst also maintaining the attainability of and not compromising the broader corporate strategies.

III. LIMITATIONS

A. Over-saturation

The use of non-financial indicators in executive pay would lose a lot of its impact and benefits if its disclosure becomes mandatory and everyone starts doing it, especially in terms of competitive advantage (Jackson et al. 2020). If firms are required to disclose their non-financial performance indicators, most firms will naturally make effort to improve these to be viewed as more favourable to potential investors and other stakeholders. Therefore, due to less differentiation, for those firms that are improving non-financial indicators through tying them to executive pay, the goodwill gained will not be as valuable.

B. Lack of guidance

On the flip side, there is currently no strict regulations, standards, or legal requirements for non-financial report (Julvez 2022). Therefore, the burden is on the firm to decide how they report their non-financial performance, how often and especially, what indicators they choose to report on. There are existing guidelines such as GRI (Global Reporting

Initiative 2021) and ESG (Envizi 2021.) that could provide the firm with a direction in how to report their non-financial performance and how often to do so.

The most complicated decision to make would be deciding on which measures to choose and the framework to measure them. Many firms do not take the time to choose the indicators that best fit the firm and would best aid them in achieving their goals. In fact, many firms just adopt frameworks such as the Kaplan and the Balanced Scorecard (Ittner and Larcker 2003). The problem with these external designed frameworks is that they may not be catered to the firm's industry and the specific goals, strategies, and projects within the firm. This may result in the indicators being unreliable. These unreliable results may cause executives to be underpaid or overpaid compared to the amount they deserve. In favor of these externally designed frameworks, they are more difficult to manipulate (Tahir et al. 2019) because they are not influenced by executives and are collected and compiled by external sources (Ibrahim and Lloyd 2011).

Alternatively, the firm could choose the indicators internally and design a framework for measuring performance internally. The time required for such a process would be time consuming and likely costly to the firm. The firm would however be able to choose indicators and design the framework to exactly fit the firm's industry and its specific needs and goals. Most firms do fail to identify the right non-financial measures (Ittner and Larcker 2003). It is vital that the firm takes the time and resources to choose the correct measures for the information produced to be useful and for the firm to stay competitive.

C. Shareholder opposition

Shareholders may be opposed to the changes in determining executive pay.

These shareholders are highly likely to be more familiar with financial measures and therefore may prefer them (Cardinaels 2010). Additionally, shareholders may view non-financial information performance indicators as too amorphous and easily manipulated, therefore lending to earnings management. It is vital that decision-makers take the time to establish and design clear goals and strategies, then decide which indicators best link to these. They can then present this along with the benefits of the changes in executive pay to the shareholders. This can reassure shareholders of the changes, so they don't pull out and the firm doesn't lose funding.

IV. Conclusion

The firm must invest time and money into the change in determining executive pay for it to be effective and beneficial. It can provide many benefits to firm including improvements to information quality and availability of information, firm reputation, market stance and broader achievement of long-term goals. The firm will be both motivated to make the change by the perceived benefits of it and will experience the benefits if done properly. Overall, it is highly effective and beneficial to various aspect of the firm, however many resources including time, money, research and effective planning and decision making must be invested into the change for the firm to experience these benefits. Spending these resources into the change will minimize the likelihood of the firm experiencing the drawbacks. Therefore, if the firm has such resources available it would be recommended to make the change. If not, it is simply not worth it.

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