Pay Governance® Advisory Services to Compensation Committees

RESEARCH
Viewpoint on Executive Compensation

The Role of Non-Financial Metrics in Annual Incentive Programs

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This Viewpoint is one in a series of ongoing articles Pay Governance will be publishing regarding the impact of COVID-19 on compensation programs. All of our Viewpoints can be found on our website at www.paygovernance.com.

Introduction

The economic shock from the COVID-19 pandemic presents large, even existential, challenges to many U.S. companies. Management teams will understandably place a top priority on restoring financial health to their companies. A key tool for focusing and motivating employees to take required actions is the annual incentive plan. However, companies may find that annual incentive financial performance goals that were set only a few weeks or months ago may no longer be attainable at target or even at threshold. Companies that are approaching the beginning of their fiscal years are similarly challenged to establish appropriate and accurate performance goals. Clearly, with the unprecedented level of market uncertainty and economic volatility due to COVID-19, most companies are unable to make confident financial projections for the near term, let alone for the full fiscal year. Johnson & Johnson's CFO, Joseph Wolk, eloquently described the process for releasing full-year guidance: "*One thing I know for certain is we're going to be 100% precisely wrong.*"[1]

In this environment, if an organization cannot establish annual incentive financial goals that are achievable, even at a threshold level, companies may wish to consider enhancing the role of non-financial performance metrics that may be more actionable yet equally critical to ensuring longer-term business success. Non-financial metrics can help ensure that employees stay motivated and focused as company operating models are recalibrated to address the impact of the pandemic. In addition, a leadership group's communication of non-financial objectives to the broader employee group emphasizes an organization's current, critical priorities and creates a shared focus on controllable activities. While introducing new non-financial metrics—or placing greater emphasis on those already in effect—may reflect a critical part of the path forward, companies will need to assess the affordability and suitability of remunerating for their achievement if financial results are meaningfully below target.

In terms of market practice, our recent studies of annual incentive plan structures show that a majority of companies in most industries use non-financial metrics in their incentive plan scorecards (e.g., strategic goals, individual goals, operational metrics, etc.). The table below summarizes the results of our recent analyses at a sample of robust industry peer sets:

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Industry	Non-Financial Metrics	
	Prevalence	Typical Weighting
Consumer Discretionary	70%	20% - 30%
Consumer Packaged Goods	55%	15% - 30%
Financial Services	53%	10% - 35%
Financial Technology	60%	20% - 30%
Information Technology	42%	10% - 35%
Insurance	83%	10% - 30%
Manufacturing	45%	20% - 30%
Specialty Retail	25%	15% - 30%
Utility	95%	25% - 40%

The recent elimination of the performance-based exception under Section 162(m) of the Internal Revenue Code gives committees the flexibility to establish or modify goals beyond what used to be the 90-day limit after the start of the performance period. For many companies, annual incentive plans now provide the ability to make discretionary, positive adjustments to performance targets if threshold performance criteria are met — even for senior executives.

Considerations

The current economic environment is different from past slowdowns; this is in part because of government mandates implemented to limit the spread of COVID-19. Most companies have quickly shifted to cost-cutting to preserve cash, margins, and the bottom line. Typical areas of focus include pay freezes (in some cases, including pay cuts), layoffs, capital expenditure deferrals, business rationalization, and a range of discretionary expense cancellations. For the top line, some companies may be positioned to ramp up revenues more quickly than in past market downturns. But other companies may need to shift their business models to thrive in a post-pandemic economy. Some areas of urgent focus may not contribute to the bottom-line in the current year but may be critical to long-term survival and future success. Placing a significant emphasis on these critical short-term objectives in annual incentives, perhaps with greater-than-typical emphasis, can be a key tool for management. While the achievement of such objectives may require a degree of subjective assessment, many compensation committees are already prepared to exercise greater discretion in assessing company performance in order to determine appropriate incentive awards this year.

Examples of non-financial objectives that Committees may include in their assessment of 2020 performance for annual incentives include the following:

- Implementing prompt workarounds to supply chain disruptions.
- Diversifying supply chain sourcing to reduce future risk from pandemics.
- Accelerating the launch of new revenue streams to offset shuttered operations.
- Retaining key (non-executive) employees critical to company capabilities.
- Maintaining employee engagement to the degree possible.
- Implementing cost control and efficiency initiatives.
- Minimizing disruptions to critical business operations.
- Ensuring that liquidity needs are met.

- Maintaining debt covenants.
- Establishing a suitable work-from-home environment, particularly from a technology standpoint.
- Enhancing operational goal weightings, such as health and safety, process improvements, etc.
- Improving disclosure of appropriate environmental, social, and corporate governance (ESG) practices and results.
- Expanding public engagement, both immediately and over a longer-time horizon, in order to demonstrate empathy with affected communities and improve customer loyalty.
- Creating a shared sense of sacrifice: voluntary reductions in senior executive compensation balanced by limiting broader employee layoffs (i.e., perhaps current executive salary reductions could partially be offset by somewhat higher year-end bonuses to the extent warranted by non-financial performance).
- Coordinating with federal, state, and local regulatory agencies on appropriately balancing continued business operations with the health and safety of citizens.

Additionally, committees could consider expanding the emphasis on other ESG-related metrics that may already be included in annual performance plans. For example, while certain gender/diversity hiring initiatives may be critical, they may not be practical (at least in the short-term) if hiring freezes are implemented. ESG measures can therefore be balanced by refocusing attention on metrics such as the promotion of diverse individuals and employee development and engagement.

As committees consider the above actions, it is important to craft a robust communication strategy around actions taken with a view to disclosure either in 8-K filings or in 2021 proxy statements. We note that both ISS and Glass Lewis issued recent papers that called on companies to disclose contemporaneously any changes made to compensation programs in 2020.

Conclusion

Prioritizing and rewarding the achievement of critical, non-financial objectives in the short run may ultimately lead to improved financial performance in the long run. It may also provide companies with a first step toward articulating a long-term sustainability strategy, which is increasingly important to a number of investors who believe that focusing solely on near-term bottom-line results may be inappropriate given the growing awareness surrounding the value of non-traditional measures of performance. Finally, adapting non-financial metrics to the current situation could help motivate employees and ensure long-term viability for the company.

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Pay Governance will return to these and other potential executive compensation strategies in subsequent Viewpoints, blog posts, and other communications. We will provide weekly updates on our website: paygovernance.com.

[1] Joseph Wolk. In: Mark Maurer and Dylan Tokar. "Johnson & Johnson CFO Warns Coronavirus Uncertainty to Make Guidance '100% Precisely Wrong.'" The Wall Street Journal. March 23, 2020. https://www.wsj.com/articles/johnson-johnson-cfo-warns-coronavirus-uncertainty-to-make-guidance-100-precisely-wrong-11585007136.