NACD Audit Committee Chair and Compensation Committee Chair Advisory Councils

Nonfinancial Metrics, Strategy, and Culture

Nonfinancial metrics are increasing in prevalence and importance. For example, 82 percent of S&P 500 companies published a sustainability report in 2016, and 71 percent of executives in a recent poll said communication to the marketplace about purpose, values, and vision was of equal or greater importance than financial results.[1] In this environment, choosing which nonfinancial measures to use to assess and communicate company performance has become an increasingly critical task for management teams and boards of directors. When carefully selected, monitored, and well understood, nonfinancial metrics that reflect a company's key value drivers can help provide employees, executives, directors, and external stakeholders a fuller picture of performance and progress toward achieving the company's strategic goals, compared with traditional financial metrics alone.

"Given the degree of transformation that virtually every company is facing, tracking progress is increasingly critical for boards and senior management teams. They need information over and above the usual financial data," said Larry Costello, former executive vice president and chief human resources officer at Tyco International. "They need stronger 'surround sound,' and it's nonfinancial metrics that add that dimension."

On October 19, 2017, the National Association of Corporate Directors (NACD), Farient Advisors, Katten Muchin Rosenman LLP, KPMG LLP, and Sidley Austin LLP cohosted a joint meeting of the NACD Audit Committee Chair Advisory Council and the NACD Compensation Committee Chair Advisory Council. At the session, audit and compensation committee chairs from Fortune 500 corporations discussed the key issues and challenges associated with the selection and use of nonfinancial metrics at the board level. Three key takeaways emerged from the discussion.

1. Link nonfinancial metrics to strategic and cultural objectives.
2. Data quality oversight is a challenge; audit committees can leverage internal audit in the oversight of the quality of nonfinancial data.
3. Compensation committees are focusing on the role nonfinancial metrics play in compensation plan design and in eventual payouts.

"Given the degree of transformation in the business environment that virtually every company is facing, boards and senior management teams increasingly need information over and above the usual financial data to track progress."

—LARRY COSTELLO, Former Executive Vice President and Chief Human Resources Officer, Tyco International

[1] Hank Boerner, *"82% of the S&P 500® Published a Sustainability Report in 2016 – Analysis Just Released on the Index Universe of Leading Companies,"* Governance and Accountability Institute, June 9, 2017; KPMG BLC, *"Connecting Social Responsibility and Strategy in the Boardroom,"* Governance Challenges, p. 10.

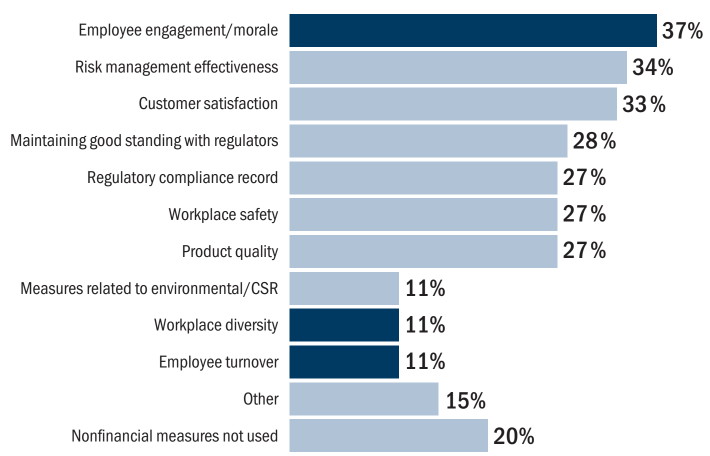
Link nonfinancial metrics to strategic and cultural objectives.

Meeting participants agreed that, as one director put it, choices about nonfinancial metrics *"should arise organically out of discussions about strategy. What do we need, as a company, to support effective execution?"*[2] For example, depending on the company's business and industry, metrics related to talent, product innovation, customer satisfaction, culture, or sustainability might be considered key for measuring performance. (See sidebar below for more on the types of nonfinancial metrics used by boards when setting executive pay. See Appendix A on p. 7 for key questions for the board to ask about the use of nonfinancial metrics.)

"We are seeing the use of non-financial metrics trend up at companies across all industries, as they help to paint a more 'holistic' view of performance, says John V. Trentacoste, partner, Farient Advisors. "However, while investors are supportive of these metrics popping up into pay plans, investors require strong disclosure regarding their inclusion and on the payout related to these non-financial metrics."

Nonfinancial metrics can also be powerful tools to reinforce a healthy corporate culture.

What are the key **nonfinancial** metrics used by your board to set CEO pay?



Source: NACD, *2017-2018 NACD Public Company Governance Survey* (Arlington, VA: NACD 2017), p. 35.

[2] Italicized comments are from delegates or guests who participated in either the meeting on Oct. 19, 2017, or a related teleconference on Oct. 25, 2017. Discussions were conducted under a modified version of the Chatham House Rule, whereby names of attendees are published but comments are never attributed to individuals or organizations (except cohosts of the event or, in limited special circumstances, when preapproved by a special guest).

Nonfinancial metrics can also be powerful tools to reinforce a healthy corporate culture. The *Report of the NACD Blue Ribbon Commission on Culture as a Corporate Asset* recommends that boards incorporate cultural criteria into discussions with management about strategy and risk and that they build cultural measures into performance evaluations. Further, the commission emphasizes that "the way directors formulate questions during reviews of business results and operating performance sends an important signal … [A]n excessive focus on quantifiable gains and losses (whether in terms of revenue, profits, market share, or other measures) can obscure or diminish the importance of purpose, values, and behaviors."[3]

Delegates viewed the task of nonfinancial metric selection as a joint endeavor between the board and senior leadership, with metrics weighted appropriately based on their importance. One director suggested, "[Board members] need to ask management, '*What nonfinancial metrics did you choose as the critical few, and why—and also what was left out, and why?*'" Board-level review and input is especially important with regard to the subset of nonfinancial measures the company chooses to disclose in external reports and communications: in a recent survey of actively managed investment funds and firms, 70 percent of respondents said they place a medium to strong weight on nonfinancial metrics and characteristics in their decisions to buy or sell a company's shares.[4]

Several directors pointed out that information from sources outside the company can help the board put nonfinancial performance data into context. Examples include information from customers, suppliers, external reviews of the company, independently conducted surveys, industry associations, and third-party indices (the latter are becoming an increasingly prevalent source of data in the environmental and social governance arena). Boards can also leverage the help of external advisors to provide a cross-industry perspective. "Interpretation [of the data] can be important," said Jason Vigna, partner at Katten Muchin Rosenman LLP. "The board may need secondary perspectives to help it to look beyond top-line results and figure out what the data means."

Given the increasing popularity of nonfinancial metrics, meeting participants also highlighted the fact that management teams and directors must avoid the temptation to increase information overload at the board level.

"Nonfinancial measures shouldn't just be more data and reports for the board to review."

—LARRY COSTELLO, Former Executive Vice President and Chief Human Resources Officer, Tyco International

[3] NACD, *Report of the Blue Ribbon Commission on Culture as a Corporate Asset* (Washington, DC: NACD, 2017), p. 18.

[4] Clermont Partners, *"More Active Investors Rely on Non-GAAP vs. GAAP Reporting in Analyzing Stocks,"* October 2017, p. 16.

"Nonfinancial measures shouldn't just be more data and reports for the board to review," said Costello. "They need to provide insight about how the company is performing against specific goals and the resulting impact on the enterprise."

Data quality oversight is a challenge; audit committees can leverage internal audit in the oversight of the quality of nonfinancial data.

Delegates emphasized that nonfinancial metrics should not be generalized as *"soft"* data. In other words, *"nonfinancial does not mean non-quantitative."* As one director noted, *"There's lots of rigor that can be applied to [nonfinancial metrics'] calculation and use."* Rigor notwithstanding, ensuring the quality and integrity of nonfinancial data, including the controls around it, is essential. Just as they do for financial reporting, directors should ask management how nonfinancial metrics are validated, and audit committees should monitor whether the company's internal controls around the data are sufficiently robust. "Audit committees will want to consider whether management has clearly defined the company's key nonfinancial metrics and has assessed the adequacy of its disclosure controls and procedures surrounding these metrics," said Jose Rodriguez, partner in charge and executive director of KPMG's Audit Committee Institute.

"It can be especially challenging in large, complex global organizations to collect and aggregate this type of data," one director explained. Several delegates noted that at their companies, internal audit's vetting process for the non-financial measures used in performance management includes reviews and tests of the sources, data controls, and the accuracy of the numbers.

Compensation committees are focusing on the role nonfinancial metrics play in compensation plan design and in eventual payouts.

When nonfinancial metrics are used in pay plans, it's important that there is a clear line of sight from each metric to the company's financial goals, and furthermore, that the rationale for those linkages is clear to investors. *"Investors are interested in the logic behind the board's choices. Why is a particular metric appropriate for your company? How does it affect shareholder value?"* one delegate said. Participants also suggested that it's important for the compensation committee to get interim reports on progress against non-

Four Critical Roles for Internal Audit

The Institute of Internal Auditors believes internal audit can play at least four critical roles as it relates to supporting organizational governance over nonfinancial reporting:

- Being a change agent for integrated thinking in the organization, a necessary precursor to nonfinancial reporting
- Participating in the project team to provide guidance to implementation plans and performance
- Providing assurance on the accuracy and reliability of the information being reported, both internally and externally as appropriate
- Partnering with external assurance providers to ensure that the engagement is performed efficiently, reliably, and cost-effectively

Source: The Institute of Internal Auditors (IIA), *Global Perspectives and Insights: Beyond the Numbers—Internal Audit's Role in Nonfinancial Reporting*, (Lake Mary, FL: IIA 2015), p. 5. Data was obtained from the CBOK 2015 Global Internal Audit Practitioner Survey (Lake Mary, Florida, USA: The Institute of Internal Auditors Research Foundation). Visit www.theiia.org/CBOK for more information.

financial metrics throughout the year, as opposed to only at the end of the performance period: *"It allows us to have better discussions and has made the committee more confident in the decisions they're making related to the nonfinancial metrics piece of the plan,"* one director said. And while "discretion can feel like a four-letter word," compensation committees should not be afraid to adjust payouts either upward or downward if they believe circumstances warrant, but they should be prepared to explain to investors why and how such discretion was used. According to one delegate, *"In a series of meetings with our top investors, they made it clear that [they think] discretion is okay, as long as it is not exercised in an indiscriminate way."*

Like all performance measures, nonfinancial metrics should be included in risk assessments of the compensation plan to avoid any potential unintended consequences and to help ensure that they reinforce, rather than undermine, the company's culture. In the 2017 *Report of the NACD Blue Ribbon Commission on Culture as a Corporate Asset*, one commissioner noted, "Each year we ask our compensation consultant to do a summary report on the incentive programs at all levels of the company, and identify any aspect of those programs that could be problematic by encouraging high-risk behavior or otherwise damaging the culture. It gives the compensation committee a new level of visibility, and also sends a strong message that the board is paying attention."[5]

Delegates also noted that not every nonfinancial metric belongs in the compensation plan. "There's a menu of nonfinancial metrics companies can use in pay plans. Choosing some and leaving some out are equally important," Trentacoste said. (See Appendix B on p. 8 for a set of questions the board could consider when determining appropriate metrics.) Metrics that are not tied to the pay plan but that are important to the business can be used in other ways as appropriate. Some metrics may be used as modifiers to incentive payouts, providing the board with additional flexibility. "For example, if successful execution of the strategy requires a transformation in the R&D function, the board can identify key milestones for progress in that area and to use as governing criteria on the annual bonus payout," Costello said. One delegate said his company ties certain nonfinancial metrics to CEO evaluations: *"We use some nonfinancial goals to round out the board's annual evaluation of the CEO. By not including them in the compensation plan, we avoid over-weighting their importance, but can still send a clear message to the CEO that we're paying attention."*

"Inside the company, nonfinancial metrics are powerful tools to focus management's attention and drive change on issues the board believes are important."

—DIRECTOR

[5] NACD, *Report of the Blue Ribbon Commission on Culture as a Corporate Asset* (Washington, DC: NACD, 2017), pp. 20-21.

Conclusion

Council participants agreed that although the board shouldn't dictate which nonfinancial metrics are used to assess company performance, directors should have robust discussions with management regarding their selection and the governance of the data and processes used, as well as updates throughout the year to monitor progress toward their achievement. The board should also understand which metrics will be disclosed, as all of the metrics used to manage the business may not be reported. In addition, directors should ensure that the rationale for any nonfinancial metrics used is clearly communicated to investors, particularly any that are included in executive pay plans.

As one director noted, *"Inside the company, nonfinancial metrics are powerful tools to focus management's attention and drive change on issues the board believes are important. Externally, they help communicate to shareholders about how the company is making progress in areas such as sustainability and innovation."*

For Further Reading

- NACD, *Report of the NACD Blue Ribbon Commission on Culture as a Corporate Asset* (October 2017)
- Sidley Austin, *"Corporate Social Responsibility: Board Oversight, Disclosure, and Engagement,"* Governance Challenges 2017: Board Oversight of ESG (March 2017)
- KPMG, *"Connecting Social Responsibility and Strategy in the Boardroom,"* Governance Challenges 2017: Board Oversight of ESG (March 2017)

APPENDIX A

Key Questions to Ask About Nonfinancial Metrics

Excerpted from NACD's *Director Essentials: Understanding Nonfinancial Metrics*, (Washington, DC: NACD, 2017) p. 19.

The following questions will help directors narrow the choice of key metrics to track. To be useful, a metric need not meet all the criteria below, but the more criteria it meets, the more important it will be.

- How does this metric reflect and support our strategy?
- Does this metric reflect a key performance driver for our company?
- What aspects of performance does this metric drive?
- Is this metric used in our executive compensation plans?
- Do we as a board understand how this metric is calculated and why it is used?
- Is this metric commonly used in our industry? Do our competitors use this metric, and if so, how do we compare with them?
- What other metrics does our industry use?
- Do we have information about this metric for past performance periods, and if so, what is the pattern?
- Is the company required to disclose this metric to investors (e.g., under the U.S. Securities and Exchange Commission's Regulation S-K as part of the annual 10-K filing), and if so, what message does it send?
- Is this metric required by executive branch agencies such as the U.S. Department of Labor or the U.S. Environmental Protection Agency? If so, is our score above or below what is considered desirable?
- Will a low score on this metric bring us negative media and/or shareholder attention?
- Is there good news that the company should promote through its website and media channels?

APPENDIX B

Special Considerations of the Compensation Committee

Excerpted from NACD's *Report of the NACD Blue Ribbon Commission on Performance Metrics: Understanding the Board's Role* (Washington, DC: NACD, 2010) pp. 14-15.

There are many factors to consider when relating incentive compensation with short- and long-term metrics. Compensation committees, chiefly responsible for this activity, should review some of the following questions:

- Do the chosen performance metrics support the basic strategy? Do they measure the key value drivers?
- Does the required performance fall within the scope of industry performance and economic projections?
- Are the performance metrics incentivizing team work or individual merit?
- Have we reviewed performance metrics as disclosed in our competition's proxy statements?
- What are the weights of varying business units? Have we placed too much emphasis on one particular unit?
- Have we placed too much emphasis on a particular individual performance factor? Have we ensured no one metric dominates?
- Are the metrics able to be communicated externally with respect to legal issues and confidential information?
- Are the short-term bonus metrics supportive of and consistent with long-term metrics?
- What are the pros and cons of using relative performance measures?
- Should there be a payout if performance is negative but beats peers'?
- Is there sufficient confidence in the integrity of the numbers and the measurement process of the metrics, whether financial or nonfinancial, to be sure that fraud or erroneous reporting would not subject the payments to clawback provisions required under the Dodd-Frank Act?
- Can the performance metrics be skewed inappropriately by non-recurring or nonoperating performance?

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About the Audit Committee Chair Advisory Council

In support of a sustainable, profitable, and thriving corporate America, NACD created the Audit Committee Chair Advisory Council. Since 2009, this council has brought experienced audit committee chairs from Fortune 500 companies together with key shareholder representatives, regulators, and other stakeholders to discuss ways to strengthen corporate governance in general and the work of the audit committee in particular. KPMG's Audit Committee Institute and Sidley Austin LLP collaborate with NACD in convening and leading this council.

Delegates of the council have the opportunity to engage in frank, informal discussions regarding their expectations for audit practices, processes, and communications, and to share observations and insights on the changing business and regulatory environment. The council's purpose is threefold:

1. Improve communications and build trust between corporate America and its key stakeholders.
2. Give voice to directors engaged in the audit arena and exchange perspectives with regulators, investors, and other important constituents regarding audit committee–related matters.
3. Identify ways to take audit committee practices to the next level.

NACD believes that the open dialogue facilitated by this advisory council is vital to advancing the shared, overarching goal of all boards, investors, and regulators: to build a strong, vibrant capital market and business environment that will continue to earn the trust and confidence of all stakeholders.

About the Compensation Committee Chair Advisory Council

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Delegates of the council have the opportunity to engage in frank, informal discussions regarding their expectations for compensation practices, processes, and communications and to share observations and insights on the changing business and regulatory environment. The council's purpose is threefold:

1. Improve communications and build trust between corporate America and its key stakeholders.
2. Give directors engaged in the compensation arena a voice and a forum in which to exchange perspectives with regulators, standard setters, investors, and other important constituents on committee-related matters.
3. Identify ways to take board leadership and compensation committee practices to the next level.

NACD believes that the open dialogue facilitated by this advisory council is vital to advancing the shared, overarching goal of all boards, investors, and regulators: to build a strong, vibrant capital market and business environment that will continue to earn the trust and confidence of all stakeholders.

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