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Sustainability-oriented targets in executive compensation – symbolic measures or significant catalyst for a sustainable transition?

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Abstract

Purpose – This study aims to analyse the motivations and underlying assumptions of decision makers driving the adoption of sustainability-oriented targets in executive compensation (SCTs) to better understand SCTs' impact on sustainability performance.

Design/methodology/approach – Through a qualitative approach, 15 in-depth interviews are conducted in a two-tier governance setting. Participants include management and supervisory board members, compensation consultants and other stakeholders involved in proxy voting.

Findings – SCT implementation is primarily determined by meeting shareholders' expectations rather than those of other stakeholders. Decision makers react in a differentiated way to increased expectations by implementing either primarily symbolic or substantive measures and encounter different implementation

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challenges like insufficient data quality and a lack of experience within supervisory boards, both of which potentially contribute to decoupling.

Research limitations/implications – The study offers valuable insights for companies in designing SCTs and emphasises the significance of addressing decoupling to effectively enhance sustainability performance through SCTs and provides a foundation for future studies aimed at analysing this phenomenon.

Originality/value – Using a neo-institutional theory lens, this study marks one of the first interview-based investigations to distinguish between symbolic and substantial SCTs. It delves deeply into the role of decoupling and the associated challenges, offering fresh perspectives within the under-researched framework of a two-tier corporate governance structure. Moreover, this study aims to meticulously capture the real-world design practices and implementation processes of SCTs through experts, an aspect that was emphasised as a limitation in previous studies.

Keywords Executive compensation, Sustainable corporate governance, Neo-institutional theory, Decoupling, Legitimacy

Paper type Research paper

1. Introductory

1.1 Background of the study

In recent years, numerous measures have been increasingly integrated into corporate governance as companies aim to improve their long-term orientation and impact on society and the environment [1] (Flammer *et al.*, 2019). Previous research on sustainable corporate governance has particularly focused on board gender diversity, board expertise in sustainability (e.g. by including chief sustainability officers on the management board or setting up sustainability committees within the supervisory board) and sustainability-oriented targets in executive compensation (SCTs) [2] (Velte, 2023). Executives, particularly CEOs, significantly influence a company's strategic direction (Walls and Berrone, 2017) and corporate governance mechanisms, such as SCTs, are of paramount significance in shaping the strategic decision-making of executives concerning sustainable business practices and the consequent creation of sustainable value (Kavadis *et al.*, 2024).

At first sight, it seems sensible to link compensation schemes to SCTs to secure the long-term existence and value creation of a company (Guenther *et al.*, 2016; Al-Shaer *et al.*, 2022). However, some researchers noted that SCTs are sometimes rather challenging to quantify and lack transparency and accountability (Flammer *et al.*, 2019; Aguilera *et al.*, 2021; Ikram *et al.*, 2023). This makes it particularly challenging to predict the development of specific SCTs, which consider long-term aspects (Bhuiyan *et al.*, 2021). Furthermore, research exploring the application of SCTs through the lens of neo-institutional theory (NIT) posits that these targets are primarily adopted to enhance legitimacy, whereas efficiency improvements, in terms of augmented sustainability performance, frequently fail to materialise (Haque and Ntim, 2020; Adu *et al.*, 2022). Thus, in this paper, we delve deeper into the implementation of SCTs to provide new insights for academia, practitioners and regulators.

1.2 Previous studies and research questions

Most existing SCT studies are quantitative, and even the few qualitative studies available primarily depend on archival data (Winschel and Stawinoga, 2019). Moreover, as indicated below in more detail, these studies provide inconsistent evidence regarding the impact of SCTs on sustainability and financial performance of companies (Haque and Ntim, 2020). One approach to explain this phenomenon is based on the argument that SCTs are repeatedly implemented from the viewpoint of anticipated legitimacy through symbolic actions without aiming for genuine substantial improvements in sustainability performance (Flammer *et al.*, 2019; Haque and Ntim, 2020; García Martín and Herrero, 2020; Adu *et al.*, 2022); a circumstance, that may be the result of a policy-practice or means-ends decoupling (Bromley and Powell, 2012) of SCTs and sustainability performance. These findings are rooted in NIT, which is particularly useful to analyse the complex interrelationship between sustainability targets, executive compensation and sustainable business strategies (Haque and Ntim, 2020; Adu *et al.*, 2022) as well as whether companies aim for substantive or symbolic changes regarding their sustainability practices (Nor Ahmad *et al.*, 2022). Thus, for our research, the insights of previous studies that have applied NIT as their analytical framework are particularly relevant as we frame our qualitative analysis in this field.

Besides a potential legitimacy focus of SCT adopting companies (Haque and Ntim, 2020; Adu *et al.*, 2022), the limited progress seen in improving both financial and sustainability performance following SCT adoption, may be also attributable to the challenges associated with their effective implementation. Specifically, post-implementation accountability and transparency remain significant concerns (Flammer *et al.*, 2019; Aguilera *et al.*, 2021; Ikram *et al.*, 2023). In response to similar claims in the context of financial targets in the past and opaque compensation plans, as well as to enhance financial reporting quality (Dehaan *et al.*, 2013; Chen *et al.*, 2015; Pyzoha, 2015; Erkens *et al.*, 2018; Natarajan and Zheng, 2019), numerous companies have implemented clawback provisions (Dehaan *et al.*, 2013; Kroos *et al.*, 2018; Huang *et al.*, 2019). Thus, if aligned with SCTs, clawback provisions might bolster sustainability reporting quality and accountability of SCTs. However, to the best of our knowledge, there are no studies investigating a potential combination of SCTs with clawback provisions, signalling a potential avenue for detailed research. Moreover, concerns have been raised that specific SCTs may divert executives' focus from other important sustainability objectives (Edmans, 2023) or that SCTs might prioritise executive benefits over broader stakeholder interests (Bebchuk and Tallarita, 2022). Additionally, SCTs may not always effectively spur environmental strategies and potentially even diminish intrinsic motivation (Francoeur *et al.*, 2017).

As of today, given the lack of qualitative studies in this regard, it remains questionable how the increasing pressure to implement SCTs (Gillan *et al.*, 2021; Radu and Smaili, 2021; Aresu *et al.*, 2022; Focke, 2022) is perceived within companies. Moreover, existing studies seldomly differentiate between different designs of SCTs and do not delve into the role of decoupling (Velte, 2024). By using semi-structured interviews to investigate the implementation of SCTs, we follow a research approach that has been successfully adopted by others in the context of sustainable corporate governance (e.g. Gerwanski, 2020; Sciulli and Adhariani, 2021) and executive compensation in general (e.g. Kostiander and Ikäheimo, 2012; Maloa, 2018). With our following research questions, we aim to provide new insights into why companies implement SCTs and what considerations underlie their design. We are also interested in instances of decoupling, which may shed light on why SCTs do not always translate into the desired outcomes. Moreover, as the widespread SCTs remain a recent phenomenon, we investigate possible implementation challenges that companies face. Thus, our three research questions state:

RQ1. Why do companies implement SCTs in executive compensation? Who are the main drivers of the implementation and what are the underlying motivations and anticipated effects of companies?

RQ2. How are SCTs designed and what best practices can be found?

RQ3. What challenges arise in the course of implementing SCTs and how do these challenges lead to decoupling?

1.3 Methodology and contribution

Adopting a constructivist research approach, our study seeks an in-depth understanding of SCTs, prioritising nuanced exploration over predictive generalisation (Power and Gendron, 2015). We conducted 15 semi-structured interviews with management and supervisory board members, compensation consultants and other external stakeholders involved in proxy voting between August 2022 and November 2023. Our interviewees are from Germany and Austria, both of which have a mandatory two-tier code law regime and a strong social market economy orientation, indicating a stronger stakeholder orientation compared to that in the Anglo-American setting (Beck *et al.*, 2020). As we will point out later in more detail, this is also reflected in the greater opportunity for employees (Bottenberg *et al.*, 2017) to participate through their representation on the supervisory board, even though representatives of block holders and institutional investors regularly exercise greater power in this body (Millet-Reyes and Zhao, 2010). Moreover, we have chosen these regimes as the European Union has implemented stricter sustainability regulations under its ambitious Green Deal project to increase pressure on companies to implement sound sustainable corporate governance tools.

By examining the views of diverse stakeholders on the drivers, design and potential effects of SCTs on sustainability and firm performance as well as implementation challenges, we offer new insights called for by previous quantitative studies (Haque and Ntim, 2020; Adu *et al.*, 2022). These new insights of our work can be summarised as follows:

- Shareholders' expectations play a pivotal role in SCT implementation, often prioritised over other stakeholder interests. Although it is emphasised that their requirements are also taken into account, direct communication channels and systematic involvement in the decision-making process are only evident to a limited extent, if at all.
- Companies react to increasing pressure to implement SCTs either through symbolic or substantial measures.
- Our qualitative analysis suggests a potential link between decoupling and challenges in achieving actual sustainability and financial improvements post-SCT implementation. Further empirical studies should substantiate this relationship.
- Lacking data quality and experience within the supervisory boards regarding SCT implementation may mainly explain why SCTs are often difficult to objectify and measure. Thus, in some cases they may appear to serve the interests of management board members more than those of their stakeholders.
- Effective sustainability-driven transformation may be possible only through dedicated commitment and robust monitoring structures of SCTs. To ensure this, it will be necessary to anchor sustainability expertise more firmly in the supervisory board. It should be noted that this expertise should not be anchored in isolation but should be strongly integrated with financial and industry expertise to prevent decoupling.

Therefore, our study makes numerous contributions to practice and theory. We provide a qualitative analysis of companies' underlying assumptions and rationale for compensating executives for sustainability performance and the interrelation between executive compensation and sustainability strategies. We add to the existing literature on SCTs with a NIT perspective and show that decoupling is a non-negligible factor in the context of SCTs. We demonstrate examples of rather symbolic and substantial forms of SCTs and offer starting points for future studies to analyse their effects in more detail. Furthermore, we explicitly refer to existing implementation challenges that currently prevent an effective implementation of SCTs in some cases. Finally, we offer suggestions for further improvement for practice and standard setters in the context of SCT implementation.

The remainder of this paper is structured as follows. Section 2 presents the theoretical background on the interrelation between executive compensation and sustainability targets. Section 3 describes our research methods. Section 4 presents the results obtained from our interviews in the context of previous studies findings. Finally, Section 5 discusses concluding remarks, potential directions for further research and the limitations of our study.

2. Theoretical framework and literature review

2.1 Executive compensation in context of neo-institutional theory

NIT has recently become a well-established theoretical approach to analyse SCT implementation (Haque and Ntim, 2020; Karyawati *et al.*, 2020; Adu *et al.*, 2022). NIT is a multi-dimensional theory (DiMaggio and Powell, 1983) that is suited to explain why companies either maintain or change their practices (Greenwood and Hinings, 1996). It is particularly relevant for investigating symbolic (legitimisation) and substantive (efficiency) aspects resulting from the divergent interests of multiple institutions and stakeholders (Haque and Ntim, 2020; Adu *et al.*, 2022). We follow these studies and use NIT to explain why a growing number of companies integrate SCTs in their executive compensation plans. Central to the NIT framework is the understanding that organisations evolve in response to both technical pressures and perceived societal expectations (Boxenbaum and Jonsson, 2020). In the context of executive compensation, this implies that companies may partially use established compensation practices to enhance their perceived legitimacy even if these might not align with their shareholders' interests but help conform to the company's environment (Meyer and Rowan, 1977; Suchman, 1995; Hayne and Vance, 2019). Thus, achieving sufficient legitimacy can lead to improved reputation (Doh *et al.*, 2010).

However, the pursuit of legitimacy can also result in homogeneous compensation contracts (isomorphism) with a limited focus on company-specific concepts (DiMaggio and Powell, 1983; Fernando and Lawrence, 2014). DiMaggio and Powell (1983) identify three mechanisms for institutional isomorphic change: coercive, mimetic and normative. As they describe, coercive isomorphism stems from formal and informal pressures exerted on companies by other organisations upon which they are dependent, e.g. shareholders, consumers, regulators, employees, etc., and by cultural expectations in the society within which organisations function. Mimetic isomorphism occurs, when goals are ambiguous or when the environment creates symbolic uncertainty and companies may model themselves on other peers. These models may be diffused unintentionally or explicitly by consulting firms. In the context of SCT implementation through compensation consultants. Normative isomorphism stems primarily from professionalisation and the belief that certain practices and structures are considered appropriate within specific professional or industry contexts. This belief may be rooted in formal education and the cognitive base produced in educational institutions, as well as the growth and influence of professional networks, which are infused into supervisory boards through their members. As a result, supervisory boards, i.e. compensation committees might implement "best" practices of SCTs to appear legitimate and rely on suggestions or demands from institutional investors, proxy advisors or other stakeholders, and they may give less consideration to firm-specific threats (Bender and Moir, 2006; Hayne and Vance, 2019).

Another concept of NIT is that efforts to respond to pressure from various stakeholders might create a decoupling of formal policies and day-to-day operations of a company (Meyer and Rowan, 1977; Westphal and Zajac, 1998; Boxenbaum and Jonsson, 2020). Intentional and unintentional actions within a company may cause actual practices to not conform to external expectations (Fernando and Lawrence, 2014). This may also be partly attributed to the existing information asymmetry, complicating stakeholders' ability to perceive a company's actual performance (Crilly *et al.*, 2016) or inconsistent stakeholder expectations (Meyer and Rowan, 1977). Thus, decoupling might explain why and how executives use compensation practices to symbolise the alignment of corporate strategies with socially accepted governance models without implementing substantive actions (Shin and You, 2017). Decoupling can occur at two levels:

policy-practice and means-ends (Bromley and Powell, 2012). Policy-practice decoupling indicates why managers fail or avoid to implement formal rules; it enables companies to adopt multiple, sometimes contradictory, policies in response to diverging stakeholder pressure without significantly disrupting daily operations (Bromley and Powell, 2012). Thus, decoupling may also be a safeguarding mechanism for companies that face diverging pressures from certain stakeholder groups (Roszkowska-Menkes *et al.*, 2022). The phenomenon of policy-practice decoupling is exemplified by the case of BP's "Beyond Petroleum" rebranding, where substantial expenditure on branding overshadowed the company's commitment to renewable energy initiatives (Graafland and Smid, 2019). Whereas means-ends decoupling explores why companies devote resources to implement measures and evaluate practices with limited connection to core targets (Bromley and Powell, 2012), exemplified by the actions of various pharmaceutical companies, which have been donating medicines that are frequently found to be past their expiry date to developing countries. This practice, undermining the intended benevolent purpose, has prompted the implementation of guidelines by the World Health Organisation to curb such counterproductive behaviours (Graafland and Smid, 2019). Means-ends decoupling prevails, especially in highly opaque domains where practices, causality and performance are difficult to understand and measure, like socioenvironmental governance (Wijen, 2014). One could also argue that decision makers may not intentionally seek to deceive their stakeholders; instead, they might lack the knowledge required to fulfil their promises. This suggests that decoupling might not necessarily be an intentional response to escalating institutional pressures (Crilly *et al.*, 2012; Crilly *et al.*, 2016).

In recent years, several studies have used the concept of decoupling to describe an emerging gap between companies' claims regarding sustainability and their actual sustainability performance, often described via an enhanced focus on CSR-reporting, juxtaposed with stagnant or unimproved actual CSR-performance (Graafland and Smid, 2019; Gull *et al.*, 2023a; Gull *et al.*, 2023b). Examining the role of key corporate governance actors in decoupling (Gull *et al.*, 2023a) report that CSR committees reduce CSRs decoupling, while Gull *et al.* (2023b) find that powerful CEOs amplify decoupling. Means-ends decoupling might also explain why companies seem to make considerable efforts to define SCTs, adjust compensation structures, and vote on them at the Annual General Meeting (AGM) despite their apparently mixed impact on sustainability and financial performance (Maas, 2018), as shown in more detail below. If not carefully executed, companies aiming to close a policy-practice gap between SCTs and sustainability performance by formulating specific targets and transferring universal best practices might create or widen the gap between means and ends (Wijen, 2014). The phenomenon of decoupling illustrates why it is suitable to examine the implementation of SCTs by means of a qualitative study. Otherwise, one runs the risk of attributing a lack of improvements in sustainability performance that arise because of half-hearted or ill-considered SCTs to other well-designed SCTs that might actually lead to improvements.

2.2 Literature review

Reiterated, existing SCT literature primarily focuses on quantitative and archival data (Winschel and Stawinoga, 2019); qualitative studies, especially in-depth interviews, are scarce. The few existing qualitative studies often focus on a content analysis of annual reports investigating how many companies use SCTs and how these SCTs are structured (Eccles *et al.*, 2014; Maas and Rosendaal, 2016; Hartikainen *et al.*, 2021; Winschel, 2021). Case studies by Kolk and Perego (2014), Cavallaro *et al.* (2018) and Nigam *et al.* (2018) supplement the qualitative research. Emerton and Jones (2019) conducted semi-structured interviews with compensation consultants and institutional investors in the UK in 2017. However, the contribution of this study to the theoretical understanding of the reasons and methods for the implementation of SCTs may be limited by the lack of a solid theoretical foundation and missing distinction between substantive and symbolic SCTs, a critical aspect in understanding the actual impact versus the perceived intention of these targets. This limitation can be partly attributed to the pioneering nature of their study at a time when SCTs were relatively uncommon, highlighting the temporal context's influence on their findings. Similarly, Rodrigue *et al.* (2013) used five semi-structured interviews with board members in the USA, providing a partial reflection of stakeholder experience, to illustrate their quantitative results. Both cited studies conducted their interviews in a one-tier governance setting and during a period when the implementation of SCTs was in its infancy, compared to the current practice, especially in Europe (Keddie and Magnan, 2023). As numerous researchers have indicated, there is still significant potential in comprehensive qualitative interview studies to unearth nuanced SCT insights (Hong *et al.*, 2016; Haque and Ntim, 2020; Aguilera *et al.*, 2021; Radu and Smaili, 2021; Adu *et al.*, 2022). Drawing on the few existing interview studies in this field, we aim to expand upon their pioneering efforts by uncovering novel insights into the implementation of SCTs.

Why SCTs are implemented can be examined mainly from two perspectives: determinants contributing to SCT formulation and the (expected) consequences following their implementation. Board characteristics such as independence (Hong *et al.*, 2016), size (Ikram *et al.*, 2023), gender diversity (Liu *et al.*, 2023) and existence and composition of sustainability committees (Abdelmotaal and Abdel-Kader, 2016; Al-Shaer and Zaman, 2019; Cho *et al.*, 2019) are all determinants that positively affect SCT implementation. Additional determinants include firm characteristics such as industry and firm size (Ikram *et al.*, 2023), increasing social and environmental regulatory pressures (Aresu *et al.*, 2022) and increasing pressure from institutional investors and the proxy advisors they commission (Gillan *et al.*, 2021; Guerci *et al.*, 2021; Radu and Smaili, 2021; Kordsachia *et al.*, 2022). Especially sustainability-focused institutional investors who adhere to the principles of responsible investment have recently become central corporate governance players and have driven SCT implementation (Focke, 2022). Moreover, companies sometimes seem pressured to adapt their preferred compensation philosophy to the best practices of proxy advisors to increase their legitimacy (Hayne and Vance, 2019). Regulation practices also strongly influence executive compensation, especially in the EU, as will be demonstrated later in this paper. Additional pressure could be exerted by other stakeholders, such as non-governmental organizations (NGOs). However, Radu and Smaili (2021) note that the demands of internal stakeholders are granted a higher priority than those of external stakeholders. The preceding discussion highlights the multifaceted expectations of stakeholders regarding the implementation of SCTs, which could, as indicated above in more detail, trigger decoupling (Bromley and Powell, 2012). To better understand these dynamics, it is important to obtain practical insights. Thus, the aim of our study is to provide new insights in this respect to better understand the reasons why and how companies implement SCTs.

To achieve this, it is also important to analyse the anticipated effects of SCT implementation. The impact of SCTs on a company's sustainability performance is well-documented; however, the results are far from conclusive. As described above, previous studies on this aspect have mainly used quantitative research approaches and used a dummy variable with a value of 1 if a company implements some form of SCTs, and 0 otherwise. This approach can also be partly attributed to the fact that database providers often do not offer a more detailed breakdown of SCTs and that new research approaches, such as AI-supported textual analysis of compensation reports, have only recently become available. Studies that use such a dummy variable regularly conclude that SCTs improve sustainability performance, as measured via sustainability rating scores (e.g. Hong *et al.*, 2016; Radu and Smaili, 2021; Al-Shaer *et al.*, 2022; Ikram *et al.*, 2023; Liu *et al.*, 2023).

Moreover, Flammer *et al.* (2019) report that SCTs lead to a stronger long-term orientation, increased social and environmental initiatives, lower emissions and increased green innovations and that SCTs are more likely to be effective if they are implemented substantially. Whereas, García Martín and Herrero (2020), who closely examine the actual effects of SCTs, state that SCTs only affect environmental performance indices while having no influence on the sustainable use of resources. Similarly, Haque and Ntim (2020) show that SCTs only increase process-oriented carbon performance but not actual carbon performance. Adu *et al.* (2022) provide additional evidence that the effects of SCTs are higher in symbolic constructs compared to actual measures. Moreover, although Cordova *et al.* (2021) and Lu and Wang (2021) report increased sustainability reporting owing to SCTs, they find no effect on actual carbon management or sustainability performance. Using insights from NIT Haque and Ntim (2020) and Adu *et al.* (2022) offer one potential explanation that SCTs might be implemented in executive compensation contracts primarily owing to legitimacy aspects and be focused on symbolic actions rather than actual improvements. García Martín and Herrero (2020) further emphasise the signalling effect of SCTs. These inconsistent results regarding sustainability performance indicate that other corporate governance aspects and contextual factors should be considered in addition to SCTs (Aguilera *et al.*, 2021). Another factor that could contribute to an increased focus on symbolic measures rather than actual improvements in sustainability performance and thus decoupling is the economic insignificance of SCTs in relation to total executive compensation (Walker, 2022).

There are only a few quantitative studies that do not rely merely on a dummy variable when analysing the effects of SCTs on sustainability performance. Distinguishing between quantitative and qualitative SCTs, Maas (2018) states that SCTs do not automatically lead to improvements in sustainability performance for S&P 500 listed firms for the years 2008–2012. Rather, only quantitative, hard SCTs seem to be a suitable approach to improve sustainability performance. In another study, Yang (2023) shows that a higher quality of SCTs [3] leads to better sustainability performance in terms of higher ratings. These results indicate that the quality of the SCTs has an influence on the expected effects. Together with the findings of Haque and Ntim (2020) and Adu *et al.* (2022) this suggests a demand for additional studies that distinguish between the effects of symbolic and substantive SCTs on actual sustainability performance (Velte, 2024). Aguilera *et al.* (2021) also emphasise the potential influence of decoupling and symbolic implementations of sustainability-oriented corporate governance measures, such as SCTs, and recommend that future qualitative studies focus more on how the resulting outcomes might be interrelated in ways that lead to substantive behaviour or decoupling.

The impact of SCTs on a company's financial performance is even more disputed. In the context of firm risk, Gao *et al.* (2023) and Uyar *et al.* (2023) indicate that SCTs might be a useful management tool. However, Khenissi *et al.* (2022) report that while including SCTs improves sustainability performance, it negatively impacts financial performance as measured by Tobin's Q and the performance of firms with a high return on equity. D'Apolito *et al.* (2019) find that SCTs negatively affect financial performance. By contrast, others state that SCTs positively affect financial performance/firm value (Flammer *et al.*, 2019; Bachmann *et al.*, 2020; Nandy *et al.*, 2022), and some report mixed results within their setting (Cavaco *et al.*, 2020). Liu *et al.* (2023) examine the joint effect of female board representation and SCTs and show that SCTs by themselves negatively affect firm performance (Tobin's Q), while female directors and SCTs jointly provide positive effects. However, Baraibar-Diez *et al.* (2019) do not find any effects of SCTs on economic performance, and Chouaibi *et al.* (2021) find that SCTs do not influence a company's cost of equity. Analysing the effects of SCTs on a company's financial performance can also provide information as to whether SCTs primarily contribute to understanding sustainability as a business case and whether the focus is on maintaining a company's long-term financial stability. This has been criticised in the past in relation to sustainability reporting (see Milne and Gray, 2013; Brown and Dillard, 2014; Stawinoga and Velte, 2022).

3. Research design, data collection and analyses

We use qualitative interviews to answer our research questions and prioritise the views, opinions and experiences of our interview partners on implementing SCTs. A few previous studies used interviews to investigate executive compensation (Bender and Moir, 2006; Guerci *et al.*, 2021); however, to our knowledge, only one focused on SCTs, in a UK setting in 2017 (Emerton and Jones, 2019). We offer a more detailed explanation at a time when companies already have more exposure to and experience with SCTs and in a different setting. Moreover, we contribute to the field by leveraging NIT as a foundational lens for our qualitative analysis. With our constructivist research approach (Power and Gendron, 2015), we do not try to clarify a particular truth or reality. Instead, we aim to draw on the expertise and practical experience of our interviewees to capture their perceptions of this complex topic (Guerci *et al.*, 2021) and to gain an in-depth understanding (Power and Gendron, 2015; Malsch and Salterio, 2016) to provide implications that may be helpful for future research in this domain. In our qualitative semi-structured interviews, we rely on management and supervisory board members, investors, compensation consultants and representatives of NGOs in Germany and Austria. Germany and Austria are particularly well-suited for our research, partly owing to extensive regulatory measures regarding SCT implementation and other governance mechanisms like a more explicit separation between control and management (Beck *et al.*, 2020).

For developing our interview guidelines and interpreting the statements of our interviewees, we gathered information from various sources:

- academic literature on executive compensation and sustainability (e.g. Haque and Ntim, 2020; Radu and Smaili, 2021; Adu *et al.*, 2022), clawback provisions (e.g. Pyzoha, 2015; Erkens *et al.*, 2018), management, accounting and organisational behaviour literature examining NIT (e.g. DiMaggio and Powell, 1983; Greenwood and Hinings, 1996; Bromley and Powell, 2012; Fernando and Lawrence, 2014);
- European regulatory setting surrounding the implementation of sustainability targets in executive compensation;
- remuneration reports of public companies in Germany and Austria; and
- policy guidelines of proxy advisors [4].

Moreover, when we prepared our interview guidelines, we followed well-established expert interview processes (Bogner *et al.*, 2014). After introducing our interview topic through some closed-ended questions to our interviewees, we followed our semi-structured interview guidelines with questions aligned with our research questions in the following areas:

- why do companies implement SCTs;
- impact of SCT design and best practices; and
- implementation challenges.

The interview questions used as guidelines within our study are provided in Figure 1. We framed our questions in an open-ended manner, aiming to refrain from directing our interviewees towards any particular course of discussion. Furthermore, contingent upon the responses provided, we delved deeper into the aspects alluded to by our interviewees. It is important for us to underscore that the interview guidelines served the sole purpose of ensuring comprehensive coverage of the topics of our interest in each interview. We did not

General Questions

Kindly elaborate on your definition of sustainability as it pertains to the operations and goals of a company	1
(if not brought up by interviewee) What is the relative significance that you place on the Environmental, Social and Governance (ESG) components within this context?	2
What future developments do you anticipate regarding the implementation of SCTs?	15
Are there any other important aspects related to incorporating SCTs that we have not yet covered in this interview and that you would like to add?	23

Why do companies implement SCTs

Who are the main drivers in determining the company's sustainability strategy?	3
Sub Q: Are the objectives of shareholders and other stakeholders taken into account?	4
What are the motives behind the inclusion of SCTs in the executive compensation?	5
Are there any conflicts of interest between shareholders, the management- and supervisory board and other external stakeholders regarding SCTs?	6
How significant is the role of national and/or EU regulators in shaping SCTs?	16
Which other stakeholders do you believe will have a substantial impact in the future?	17
What specific impacts do you expect linking sustainability targets and executive compensation to have on the advancement of sustainable business practices and development?	18
Do you believe that incorporating SCTs enhances the social legitimacy of a company?	19

Impact of the Design

Can you describe the procedure for setting sustainability targets to be reflected in executive compensation, including the stakeholders involved and the factors considered?	7
What is your perspective on the impact that the design of SCTs has on the achievement of climate neutrality and overall business success?	8
Are SCTs included in the executive compensation policy of your company (those you consult)?	9
(If yes and not elaborated by interviewee), please specify which aspects are considered, to what degree, and the underlying considerations. (If not) what is the rationale for this?	10
Are SCTs closely aligned with key drivers of business performance?	11
Is there a common approach to incorporating SCTs across companies, or do they vary based on unique stakeholder pressures? Are there companies leading the way in this area and if so, what sets them apart in their approach?	12
Are SCTs incorporated into short-term and/or long-term executive compensation? and if so, in what form (cash or equity)?	13
What is the reasoning behind the chosen implementation method?	14

Implementation Challenges

What challenges are associated with implementing SCTs?	20
(if not brought up by interviewee) How do you evaluate the knowledge and experience of your supervisory board (supervisory boards in general) regarding SCTs?	21
How do you evaluate the feasibility of implementing clawbacks in the event of failure to reach environmental and/or social sustainability targets or setting unambitious goals in these areas?	22

Source: Authors

Figure 1. Interview guideline

I No.	Interviewee description	Represented group(s)	Minutes
I-1	Investor, former executive, and member of supervisory boards of public companies	Investors	66
I-2	Managing Partner at a compensation consultancy	Compensation consultants	47
I-3	Chairman of the supervisory board of a public company in and member of multiple supervisory boards, former CEO of a public company	Company representatives	43
I-4	Member of multiple supervisory boards of public companies	Company representatives	60
I-5	Member of multiple supervisory boards of public and private companies	Company representatives	35
I-6	Advocate for employees' interest	Other external stakeholders	34
I-7	CEO of a public company	Company representatives	32
I-8	CEO of a sustainability-oriented marketing and communications agency that works with listed and medium-sized companies on their sustainability strategies	Sustainability consultants	37
I-9	Senior Director at a compensation consultancy	Compensation consultants	41
I-10	Director at a compensation consultancy	Compensation consultants	73
I-11	Senior Director at a compensation consultancy	Compensation consultants	42
I-12	Head of Group Sustainability of a public company	Company representatives	47
I-13	Advocate for investors interest	Investors	Written + 15
I-14	Expert regarding corporate governance and employee co-determination on supervisory boards	Company representatives, Other external stakeholders	44
I-15	Member of a commission dedicated to advancing responsible corporate governance from the perspective of investors; Co-Owner and Senior Board Advisor at a Supervisory Consultancy	Company representatives, Other external stakeholders, Investors	37

Source: Authors

Figure 2. Description of interviewees

rigidly adhere to the indicated sequence of the questions, rather, to maintain a conversation flow devoid of influence, we directed our questions according to the specific topics emerging from our interviewees' responses.

We selected interviewees so as to include representatives from various stakeholder groups to capture the multi-layered nature of internal and external stakeholders. Figure 2 summarises the interviewees' background information. Our selected management and supervisory board members from German and Austrian publicly listed companies have already implemented SCTs and can, therefore, share their underlying considerations and accumulated experience. The remuneration consultants interviewed work with numerous supervisory and management boards of listed companies in Germany and Austria and can thus report insights from SCT implementation processes at different companies. A consultant's comments on general sustainability strategies at listed and non-listed companies provide a more in-depth background on the companies' sustainability strategies, and the information received from our interviewed external stakeholders (investors and employee representatives) provides an external perspective in this context. Thus, our interviewees help us to capture an extensive range of expertise and perceived impacts to ensure an in-depth understanding to answer our research questions in line with NIT. The interviewees were contacted via email, informed about the content and purpose of the study and then asked whether they were interested in participating in our study. Subsequently, for our first interview round appointments were made with the interviewees between August 2022 and February 2023.

The 11 interviews of this initial round were held partly in person and partly via Zoom/Microsoft Teams, and they lasted 31–73 min with an average of 46 min. All interviewees were informed in advance that the interview would be recorded for transcription purposes and that their statements would be anonymised so that no conclusions could be drawn about their person or organisation. In line with other studies, we stopped our initial interview process after reaching a sufficient level of saturation, that is, the point at which no significant new findings emerged from the explanations and answers were predominantly aimed in the same direction (Malsch and Salterio, 2016). Nevertheless, following an initial comprehensive analysis of our findings, we conducted four additional interviews between October and November 2023 [5]. Apart from one interview, where the interviewee (I-13) initially answered the question in writing and then went verbally into more detail on aspects that we considered particularly relevant in a follow-up appointment, the procedure of the first round of interviews was retained. As a result, we conducted a total of 15 interviews, with the findings from the four additional interviews largely confirming the previously collected results and contributing to an even more detailed understanding. Eight of our 15 interviewees could be categorised more strongly to Austria and seven towards Germany. Given that the majority of our interviewees have extensive expertise regarding executive compensation in both countries and the similar governance structures and ideals in Austria and Germany, their primary location has no profound significance for our analysis.

We explicitly chose Germany and Austria as they have a mandatory two-tier system, which seems particularly well-suited as the functions of management and control are more strictly separated (Beck *et al.*, 2020). Additionally, in a two-tier system, employees can exercise their influence through participation in the supervisory board due to co-determination principles. Within listed companies employing up to 2,000 individuals, a mandatory requirement dictates that one-third of the supervisory board must comprise employee representatives. For enterprises exceeding 2,000 employees, this proportion escalates to one-half (Bottenberg *et al.*, 2017). Nevertheless, blockholders and institutional investors are regularly very prominently represented and exert great influence on the supervisory board (Millet-Reyes and Zhao, 2010). In this corporate governance regime, executive compensation is usually negotiated between the supervisory and management board, with supervisory board members acting as intermediaries for shareholders and stakeholders. Moreover, both countries are member states of the EU and face stricter regulatory requirements regarding implementing sustainability targets in executive compensation than countries from other parts of the world [6]. Accordingly, it is easier to gain a holistic understanding of the perceived influences and challenges of integrating SCTs for executive compensation without running the risk of examining a phenomenon that is too focused on a severely limited local context. Moreover, Germany and Austria are well known to have a social market economy system where, besides economic aspects, non-economic factors are also considered more strongly than in purely capitalist market economies (Inshakova *et al.*, 2021). Therefore, we expect to find sufficient interlocutors in Germany and Austria who are aware of the importance of SCTs and can provide meaningful inputs regarding their potential consequences.

All interviews were transcribed by the respective interviewer following the conversations. We decided to prepare the transcripts by hand, as the intensive engagement with the interviews allow us to take another deep dive into our raw data and to conduct a more detailed subsequent analysis, for which we used MAXQDA to structure the transcripts and code our data. We performed qualitative content analysis according to Mayring (2015). In addition, we followed practical tips provided by Kuckartz and Rädiker (2020) for conducting qualitative interviews with experts. Firstly, we formed generic categories based on our interview guidelines with reference to our formulated research questions. Then, we identified more specific potential subcategories from the data material, reviewed this list to identify any redundancies or overlaps and consolidated similar categories into broader themes. We then reviewed the consolidated themes to ensure they accurately captured the data and were relevant to our research questions. Our data also led to a refinement of our research questions, as we were able to obtain more in-depth information.

One issue we faced was that our interviews were conducted in Germany and Austria with German-speaking interviewees. Anticipating that our interviewees would be able to contribute their expertise much more comprehensively in their mother tongue, the 15 interviews were conducted in German. However, because direct quotations are an essential quality criterion of qualitative studies (Messner *et al.*, 2017), we had to translate the quotations. Feldermann and Hiebl (2019) provide guidelines on how non-English native speakers should deal with such issues and suggest that researchers should fully disclose the translation process. We decided that the respective interviewer should translate the corresponding quotes as he would know best how to judge their meaning. The remaining co-authors subsequently reviewed the translations and sharpened the necessary passages in consultation with the interviewer. Through this process, we aimed to authentically reconstruct and recreate the original meaning of the quotes. Despite our best efforts, we cannot guarantee that subjectivity risks and loss of certain meanings arising from the translation (Lee, 2014) have been completely eliminated.

We are aware that the focus on Germany and Austria is associated with some limitations of our results. However, we have deliberately chosen this framework. On the one hand, the general conditions described here suggest that a broad base of stakeholders has expertise in SCTs, and on the other hand, SCTs can play a greater role in this often-neglected governance structure.

4. Results and discussion

We report on the reasons for implementing SCTs, roles of various stakeholders and motives for their introduction. We then examine what those responsible pay particular attention to when implementing SCTs, how rigid SCTs are and whether best practices can be derived. We also examine whether the design of certain SCTs may reflect merely symbolic measures or seriously support corporate sustainability performance, what role decoupling plays in this context and what challenges may stand in the way of a more effective implementation.

4.1 Why do companies implement sustainability-oriented targets in executive compensation?

4.1.1 Drivers of sustainability-oriented targets in executive compensation. Our interviewees indicate that the main responsibility for the general formulation of sustainability strategies lies with the management board, with the supervisory board in opposition. These bodies face increasing pressure from the capital market, regulators and other external stakeholders to address sustainability issues in their companies. Most of our interviewees consider shareholders and consumers of utmost importance in this respect. They also anticipate that younger generations, among other external stakeholder groups, will exert more pressure on companies to address sustainability strategies. Accordingly, local communities and employees are expected to become more involved. Our interviewees believe that the responsibility for decisions on whether certain products or services that may be harmful to humanity should continue to be produced and offered should not rest solely on the capital market. (I-1) states:

> And in the field of ESG in particular, I think there are definitely issues where the legislator is massively required […] I can't say, hopefully the investors will figure it out, the legislator must do something. (I-1)

It becomes clear that companies are exposed to different requirements from various stakeholder groups, which harbours the risk of isomorphism and decoupling of the resulting adaptations (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Boxenbaum and Jonsson, 2020). Thus, SCTs that are implemented more regularly due to the increasing pressure need to be analysed in this respect. In the two-tier governance system, the responsibility to implement SCTs lies within the supervisory board (i.e. compensation committee). Our results add to previous work (Guerci *et al.*, 2021; Radu and Smaili, 2021; Focke, 2022) and indicate that investors' demands are the main driver for implementing SCTs. In this context, we derived from our interviews that although sustainability becomes more important for investors as well, the interests between investors and other stakeholders are not always aligned. Aspects such as the time horizon or a primary focus on profitability harbour potential for conflict:

> When it comes down to the wire, investors have other interests, which are now also more long-term orientated, but not always in every case […] Regarding compensation, investors clearly have the upper hand with Say on Pay. One must give investors credit for the fact that they have also pushed the issue of sustainability in recent years. But the investors have the decisive power, so nothing is done that doesn't pass at the AGM. (I-14)

The predominant focus on shareholder interests may be partly attributable to the extensive participation rights of shareholders under current legal frameworks such as the Shareholder Rights Directive II and the resulting say on pay. Such a vote almost inevitably contributes to the enhanced prominence of shareholder requirements compared to that of external stakeholders in this context, as outlined by Radu and Smaili (2021). The dominant role of shareholders might result in SCTs focusing on sustainability aspects important to them, which may not coincide with the interests of other stakeholders. This raises questions about the validity of the argument that SCTs take greater account of the interests of (external) stakeholders (Nigam *et al.*, 2018). The lack of established systematic communication channels for stakeholders, as opposed to shareholders, also underscores this point.

Interviewees addressing the impact of external stakeholders on the implementation of SCTs stress the safeguarding of their interests. However, aside from extreme cases, it remains unclear how these stakeholders, other than employees represented on the supervisory board, can effectively make their voices heard. The statement of (I-15) illustrates this tension quite clearly and indicates that at least employees can also exert some influence through their representatives on the supervisory board:

> It depends on how [institutional] investors perceive their role. If they understand it in the sense of good stewardship and not only pay attention to short-term share price developments, but also attaining social objectives in the best interests of their clients, then you've got the mechanism. Moreover, in Germany, with employee representatives present on the supervisory board, it would be inaccurate to say SCTs lack representation of other stakeholders' interest. (I-15)

Thus, as stated by others (Karyawati *et al.*, 2020; Radu and Smaili, 2021; Gillan *et al.*, 2021), our interviewees suggest that employees and the increasing pressures from society, customers and regulations play an essential but rather indirect role in SCT implementation. Interviewees also largely agree that legislation is needed for establishing some basic requirements but should not be excessive. Companies should actively communicate with the capital market and establish further measures, instead of solely orienting to existing or expected regulations:

> It [the implementation of SCTs] is such an essential element of actually any corporate strategy by now. It is demanded by the capital market, it is demanded by customers, it is demanded by regulators. For me, the question can really be answered like this: there is no reason not to do it, one must do it. (I-4)

Reiterated the main drivers of SCT implementation can be summarised as follows:

- *Supervisory board*: in a two-tier governance system, the supervisory board, especially the compensation committee, plays a pivotal role in SCT implementation.
- *External pressure*: while there is a broad external pressure on companies, emanating from the capital market, regulators, consumers and societal demands, the spotlight is majorly on shareholder interests. This emphasis stems from shareholders' extensive participation rights under current legal frameworks, which results in their interests taking precedence over other stakeholders in the context of SCTs.

4.1.2 Motives and expected consequences. Our interviewees agree that implementing SCTs is reasonable. They argue that reasonable SCTs may reinforce the moral responsibility within the management board with regard to sustainability-related issues, as SCTs prominently present the priority of such measures to the public. Our interviewees emphasise that well-integrated SCTs could also serve as some form of risk management that helps to shift the focus of executives to pursue a long-term oriented strategy. Thus, one may argue that SCTs refocus executives on sustainability issues and establish measurable processes to better oversee these matters. Furthermore, a stronger sustainability focus can be seen as a capital resource factor. Companies that do not implement such targets may be confronted with negative consequences when raising capital, as many investors push for the implementation of sustainability targets. This is consistent with the results of previous studies, e.g. Aguilera *et al.* (2021) and Focke (2022). As (I-2) states in this context:

> I believe that in today's multiply interconnected world, which has economic, ecological, and social aspects, it is simply no longer possible for a company to operate without actively managing these environmental relationships. (I-2)

Although some interviewees, like (I-4), express caution regarding the causal link between SCTs and sustainability performance, the majority of our interviewees strongly believe that SCTs can support climate neutrality goals, despite most bonus payments still being tied to financial targets. Our interviewees emphasise the importance of the process initiated by the implementation of SCTs over the mere incentive mechanism. If SCTs are considered in executive compensation, they will also impact lower management positions in the long term. Moreover, the supervisory board must deal with the sustainability concept, and it, including SCTs, must be presented to the public (e.g. within the framework of the general meeting on the compensation plan and report). Thus, SCTs must not be set arbitrarily; otherwise, one's company might be exposed to fierce criticism and care must be taken to ensure that SCTs are comprehensively integrated into the existing corporate governance system. In conclusion, the signalling effect of SCTs highlights their influence on broader organisational levels beyond the management board. The remarks of (I-15) align with this signalling perspective:

> The fact that SCTs are included in the compensation gives it greater visibility out of a supervisory board perspective, but also as a management board perspective. I believe that it is not so much the direct effect, in the sense that we are reducing emissions, because that is included in the executive compensation, but that companies are thinking about how to implement it, how to control it, that will have a major impact on companies because it is also highly symbolic. (I-15)

Accordingly, based on the statements of our interviewees, one may deduce that setting SCTs in isolation does not automatically lead to improvements in sustainability performance. This suggests that a lack of substantial improvements in sustainability performance may be due to means-ends decoupling of such policies, especially if SCTs have a weak connection to the company's core targets (Bromley and Powell, 2012) or remain opaque (Wijen, 2014).

Against the backdrop that companies will generally focus on a strong sustainability-oriented corporate orientation and that executive compensation should not be structured in a way that is detached from corporate management and evaluation, our interviewees feel that the importance of SCTs will increase further:

> Well, executive compensation and the targets in variable compensation are not detached from the question of how companies are assessed, evaluated, and managed, but are sensibly strongly aligned. So, I believe that the way companies are managed, but also the way they report their success, will increasingly include non-financial components. (I-2)

Simultaneously, the statements of some of our interviewees indicate that there is a clear expectation that the implementation of SCTs must also pay off economically (i.e. in the form of a higher company value) and not just be agreed out of pure altruism. Thus, sustainability is understood as a business case, as also shown by Milne and Gray (2013), Brown and Dillard (2014) and Stawinoga and Velte (2022). This is hardly surprising given that, as described above, shareholders have the strongest influence on executive compensation, whereas external stakeholders only exert indirect influence, which should nevertheless not be underestimated. Thus, SCTs will probably not provide room for sustainability strategies which conflict with the creation of shareholder value. If the goal is to prioritise the interests of external stakeholders over generating shareholder value, given the current legal framework (say on pay), other governance mechanisms beyond SCTs may be required.

In the face of escalating institutional pressure from shareholders, consumers, legislators and other stakeholders, which may lead to an increased coercive isomorphism, it is a misconception to assume that the integration of SCTs would invariably enhance actual sustainability or financial performance. Drawing from NIT, it is imperative to distinguish between substantive changes and mere symbolic adaptations. Specifically, the phenomenon of coercive-, mimetic- and normative-isomorphism may lead organisations to conform to perceived expectations (DiMaggio and Powell, 1983), thereby fostering a legitimacy-focused approach rather than genuine organisational change as indicated by the results of Haque and Ntim (2020) and Adu *et al.* (2022). In some cases, our interviewees expect rather symbolic and process-oriented effects from the implementation of SCTs in executive compensation. Accordingly, they do not believe that SCTs in themselves are the reason for sustainability performance improvements. Rather SCTs may provide the impetus for processes and structures in a company that indeed lead to long-term improvement. Consequently, this can give rise to policy-practice and means-ends decoupling, where the adopted measures are detached from their intended outcomes. As such, one should critically examine whether institutional pressure induces genuine transformative changes or merely symbolic gestures in the realm of SCT. Moreover, whether linking executive compensation to SCTs enhances legitimacy among the general public remains debatable. Implementing SCTs might lead to higher legitimacy owing to increased credibility; however, their specific design must be considered carefully. During our interviews, we observed that the appropriate level of executive compensation is an important aspect that was raised from several sides during the legitimacy discussion. If implementing SCTs merely leads to a further increase in compensation, it will find less acceptance in society. Thus, to shed light on the actual dynamics and implications of these institutional pressures, below, we delve into the mechanisms of how SCTs are implemented in practice.

4.2 Impact of sustainability-oriented targets in executive compensation design and best practices

Regarding SCT design, our interviewees state that two considerations are of particular importance for companies. Companies try to promote developments through SCTs that contribute to a significant cost reduction. This supports previous studies indicating that companies understand sustainability as a business case (Jauernig and Valentinov, 2019). Additionally, companies include certain SCTs because they are particularly in the public eye, potentially leading to a higher isomorphism of executive compensation. In this context, company representatives regularly reference a reduction in CO_2 emissions which can be partly attributed to the increasing regulatory pressure described above. However, according to our interviewees, the level of specification of SCTs varies across companies. Currently, SCTs often only affect a minor part of the total variable compensation components and are, due to a lack of experience within supervisory boards, subject to a trial-and-error process. This implies a rather symbolic implementation of SCTs as also specified by (I-15), who emphasises the symbolic power of such goals, but also their potential in terms of sustainability transformation:

> The first is, and I don’t mean prioritisation in the order, a bit of symbolism to the outside world […] And unfortunately, I think that’s one of the reasons why some companies do it. On the other hand, when companies think about what a [sustainability] transformation means for their company, they must think about which targets are relevant for them. (I-15)

Moreover, others like (I-10) underscore that a purely symbolic implementation of SCTs cannot be sustained in the long term. When tying executive compensation to SCTs without an alignment to genuine sustainability performance, due to the existing legal regulations in Germany and Austria supervisory board members could face legal ramifications, including financial penalties. Furthermore, the relationship between the company and its investors could be adversely affected:

> And if I have simply not set ambitious targets, or only set symbolic targets, and in the end still transfer money from the company to management board members for a target achievement that is

> fictitious, then the members of the supervisory board are liable with their private assets and are liable on the grounds of breach of trust. And the investors will also let this go through at most once. (I-10)

This suggests that it is prudent for corporations not to merely give superficial acknowledgement to SCTs or use them as a strategy for management board members to augment their overall compensation through the establishment of undemanding objectives. After all, the pursuit of such targets offers little to no additional benefit to the company.

Another issue regarding the design of SCTs is the optimal timeframe for implementing SCTs. The debate whether SCTs should be implemented in long-term (LTIs) or short-term (STIs) incentive plans elicits diverse viewpoints. Proponents of a short-term orientation argue that their annual renewal facilitates adaptability to technological changes. However, as pointed out by some Interviewees (I-4, I-10 and I-14), many sustainability strategies and, thus SCTs can only be broken down into a short-term period to a limited extent, as supported by findings from Wang and Bansal (2012) and Bhuiyan *et al.* (2021). These perspectives underscore the necessity of embedding SCTs within LTIs to reflect the inherently long-term nature of sustainability strategies.

An exclusive implementation of SCTs within an STI also harbours the risk of means-ends decoupling due to the inconsistency of time frames. Thus, most interviewees advocate for SCTs' integration in long-term compensation in some form to accord with shareholders' expectations. This could be achieved through annual targets that ensure continuity or through targets that are to be achieved over a longer term. Currently, companies tend to implement SCTs predominantly within STIs. In response to the query posed by Keddie and Magnan (2023), our findings suggest that while the long-term nature of sustainability strategies might initially make it seem counterintuitive, there are instances where SCTs can fittingly be incorporated into STIs, provided these STIs are monitored over an extended timeframe. Nonetheless, the implementation of certain targets appears more viable within LTIs.

In synthesising the insights from our interviews, it becomes evident that the adoption and effectiveness of SCTs hinge on the interconnected best practices:

- organisational framework;
- relevance to core business; and
- and measurability and communicability.

This triad not only underpins the practical application of SCTs but also their strategic alignment and accountability mechanisms. The necessity of a robust organisational framework underlines the importance of not just having sustainability strategies in place but also ensuring these strategies are operationalised through dedicated roles and processes. This foundational step ensures that SCTs are not merely symbolic gestures but are integrated into the company's operational fabric. Furthermore, the responsible individuals should ensure that selected SCTs are particularly relevant to the company's core business. Finally, the most important aspect mentioned by our interviewees is that the selected SCTs must cover aspects that are well-measurable and presented in an understandable way to ensure objectification and accountability towards third parties as well. (I-11) summarises these suggestions as follows:

> One is that they [SCTs] are chosen because they are relevant, or at least they should be, because they are derived from the strategy and the background of the company. The other thing is that they should be measurable. And then, ideally, they should also be communicable. (I-11)

However, the interviews also surfaced a critical tension between the ideal state of SCT implementation and the current practices. The concern over decoupling and isomorphism highlights a gap between sustainability aspirations and reality. This gap poses a threat to the integrity of sustainability efforts, suggesting a need for a more rigorous and strategic approach to SCT selection and implementation. In this context, our analysis reveals that targets which are quantifiably precise, thereby minimising ambiguity and promoting clarity, are preferred over opaque multipliers. This approach might also mitigate the likelihood of protracted debates during the AGM. Moreover, previous work has raised concerns regarding the perceived economic insignificance of SCTs (Bebchuk and Tallarita, 2022; Walker, 2022). In the context of our two-tier setting, it is evident that there is a growing awareness of the need to incorporate SCTs as a substantial component of total remuneration. The majority of interviewees stress that at least 20%–30% of total compensation should be tied to SCTs. Partly, there is an expectation that this share will continue to increase in the future, although it is not assumed that SCTs will ever take up a larger share of total remuneration than financial targets. However, further empirical evidence is needed to substantiate these projections and trends.

4.3 Implementation challenges

As shown above, efforts to respond to pressure from various stakeholders may result in higher isomorphism and decoupling of formal policies and day-to-day operations (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Westphal and Zajac, 1998). Thus, in the context of SCTs diverging stakeholder demands and conflicts of interest emerging within different stakeholder groups (Baraibar-Diez *et al.*, 2019) could lead to decoupling (Bromley and Powell, 2012), where SCTs may not have a strong link to a company's core targets or not lead to intended outcomes. The implementation of certain SCTs, primarily because of public pressure without being firmly anchored to the core strategy of a company, can be considered a symbolic response to legitimacy aspiration. This phenomenon has already been investigated in previous quantitative-archival studies (Haque and Ntim, 2020; Radu and Smaili, 2021; Adu *et al.*, 2022), according to which companies try to increase their legitimacy and implement socially accepted practices. Our results provide the first qualitative insights in this regard by examining the underlying considerations of decision makers when implementing SCTs and distinguishing between different forms of SCTs.

Depending on the design, one might argue whether companies strive for substantial change or focus on symbolic actions that cause decoupling. For example, if companies use SCTs only as an opaque multiplier for compensation based on financial indicators one may doubt whether these targets provide more than a symbolic signal. Although companies are increasingly setting hard quantified targets that can be measured and controlled effectively, some still face challenges and need to improve the measurability of their SCTs. From a legitimacy-focus perspective, this may explain why numerous studies have so far failed to demonstrate any positive effects of SCT implementation on sustainability performance that go beyond symbolic measures, as indicated by others (Haque and Ntim, 2020; Radu and Smaili, 2021; Adu *et al.*, 2022).

Regarding the underlying expectations of SCTs, we also acknowledge the recurrent criticism of individual studies on SCTs. As explained above, Edmans (2023) argues that when implementing SCTs, executives may focus on these targets while ignoring other aspects of sustainability. In this context, (I-10) contrastingly states:

> How is this different to other targets? That [shifting the focus of executives on certain aspects] has always been the case. (I-10)

Bebchuk and Tallarita (2022) further argue that if SCTs lack transparency and sensitivity to actual performance, they may, at best, lead to improvements in the welfare of a sub-group of stakeholders while neglecting agency problems; thus, they might mainly serve the interests of executives. While interviewed members of supervisory and management boards emphasise that SCTs are regularly aligned to issues that directly affect the financial performance of their company (e.g. cost savings due to lower emissions or reduced water usage), investors and compensation consultants note that the implementation and target complexity within some companies can be improved. Poorly chosen SCTs could lead to situations where management board members take arbitrary measures to beat specific SCTs without substantially increasing actual sustainability performance. Thus, our interviewees similarly note that, if not carefully structured, SCTs might primarily provide benefits for executives without generating higher stake- or shareholder-value (Bebchuk and Tallarita, 2022). As (I-1) states, one must ask:

> Is the way in which I enter such non-financial targets something that makes sense for the development of the company or is it more of a tendency to take arbitrary measures that are not decisive for the company? Especially the issue of insourcing/outsourcing, where I can alter so much just to achieve some target parameter. (I-1)

Despite the efforts to establish SCTs effectively, many challenges remain. Based on our interviewees' statements, we have identified two main categories. Firstly, the availability, quality and preparation of data often pose particular challenges for companies. As (I-4) summarises:

> To put it simply, there [data quality for SCTs] we are where we were with financial targets 30 years ago. In order to implement the process of data collection, data consolidation, the entire ICS checks and balances, we are at the very beginning in the area of non-financial reporting […]. (I-4)

As a result, SCTs might lack measurability which could lead to more subjective SCTs (Ikram *et al.*, 2023), which, in turn, weakens objectivity and provides arguments for those who see SCTs as an ineffective bonus tool and argue that management board members can extract rents without generating substantial positive effects for shareholders or stakeholders (Bebchuk and Tallarita, 2022). Insufficient data regarding the underlying processes may hinder their measurement and management, thus explaining why previous studies have only found symbolic improvements in sustainability performance and not an increase in actual sustainability performance (Haque and Ntim, 2020; Radu and Smaili, 2021; Adu *et al.*, 2022). However, according to our interviewees, those responsible should not only focus on easily measurable SCTs but also be careful not to lose sight of the overall objective (improving sustainability and financial performance) and consider targets that seem well-suited to contribute to the actual intended outcome; otherwise, means-ends decoupling (Bromley and Powell, 2012) might occur.

Given the concerns over SCTs' measurability and accountability, we consulted our interviewees about the potential of integrating clawback provisions, known to enhance accountability and reporting quality in the context of financial reporting (Dehaan *et al.*, 2013; Chen *et al.*, 2015; Pyzoha, 2015; Erkens *et al.*, 2018; Natarajan and Zheng, 2019), to address these challenges in SCTs. Within large public companies, clawback provisions may be found in numerous executive compensation contracts, driven largely by institutional investor pressure. However, these investors may not delve deep into these provisions, focusing more on retrospective enforcement. (I-10)'s comments echo a similar sentiment:

> In this respect, I would say that these clawback clauses, yes, they are included, but no matter which member of a management- or supervisory board I speak to, this is attributable to

> completeness. No one has ever spoken to me about the content of these clawback clauses, at any time. They are accepted, they are state of the art, at best they are never used. (I-10)

Moreover, worries exist that clawback provisions might stifle necessary business risks, echoing findings by Mahdy (2019) and Deng *et al.* (2022), who investigated an American setting. The added ambiguity through clawback provisions could deter sustainability investments and enlarge executive pay disparities, adding to prior studies (Brink and Rankin, 2013; Gillan and Nguyen, 2016; Kroos *et al.*, 2018). This may result in an increasing imbalance between executive compensation and the salaries of the rest of the workforce or ultimately even deters potential executives. Thus, the direct linkage of clawback provisions to SCTs was viewed sceptically, and the central challenge, as highlighted by our interviewees, remains the measurability of SCTs:

> If measuring the sustainability targets is already bad, then there is always an eternal discussion between the supervisory board and the management board regarding the amount of bonus payments […] And with clawbacks it's even more difficult, because executives would have to pay it back. No, in my view that's an almost unmanageable path! (I-7)

The second main challenge is that many supervisory boards lack experience and expertise in formulating effective SCTs. As elucidated above, the implementation of sustainability-oriented corporate governance measures like SCTs is a relatively recent phenomenon. Our interviewees acknowledge substantial efforts by companies to advance in this domain. However, they also admit the persistence of challenges for certain firms, underscoring the necessity for these entities to first acquire the requisite expertise and experience.

Using an empirical approach, Yang (2023) also shows that sustainability expertise in remuneration committees is crucial for the quality of SCTs and their impact on sustainability performance. Lack of experience may cause increased uncertainty, which is a main driver of mimetic isomorphism (DiMaggio and Powell, 1983). This mimicry, while potentially providing short-term benefits or appeasing stakeholders, does not guarantee meaningful integration of SCTs in executive compensation. A hazard of this approach is that companies might adopt SCTs superficially without substantial improvements in financial and/or sustainability performance and, in the worst case, even counteracting them, leading to a disjunction between adopted practices and their intended outcomes, as described by means-ends decoupling (Bromley and Powell, 2012). Thus, although all interviewees agree that great efforts are being made to improve in this regard, doubts remain as to whether, from today's perspective, meaningful targets are genuinely being set throughout all companies:

> It remains questionable whether meaningful targets are being formulated at this point in time. Since a wrong target might lead to greater damage than no target, companies should be careful when formulating sustainability targets. (I-4)

5. Conclusion

While prior research on SCTs has predominantly used quantitative methods (Winschel and Stawinoga, 2019), our study contributes to the field through in-depth qualitative interviews, albeit with a limited but diverse group of 15 stakeholders. Rooted in NIT, our constructivist research offers new insights regarding why and how executive compensation is linked to sustainability related matters in two EU member states with mandatory two-tier system (Germany and Austria) and underscores the critical role of decoupling and isomorphism in shaping SCT practices.

Our results show that while companies face pressure from various stakeholders to pursue sustainability strategies, shareholder demands are most crucial for implementing SCTs and shaping the decisions of supervisory boards. European regulations such as say on pay, which have reinforced shareholders' rights in terms of involvement in determining executive compensation, as well as sustainability-focused institutional investors (Focke, 2022) have so far intensified this tendency. Our interviewees report that this focus on shareholders, in some cases, may lead to a form of isomorphic behaviour, where companies adopt SCTs primarily to conform to shareholder expectations, potentially neglecting broader sustainability interests or company specific topics.

It seems that while some companies implement specific SCTs that are derived from and closely linked to their corporate strategy, others appear to adopt a more ambiguous approach (e.g. incomprehensible sustainability-oriented multiplier of financial targets). Our interviewees suggest that companies seeking to enhance sustainability and financial performance through SCTs should derive these objectives from overall sustainable corporate governance strategies and align them closely with the core objectives of the company. In addition, companies should ensure that a sufficient data basis is provided, goals are objectively measurable and they are transparently prepared for external evaluation. Otherwise, information asymmetry could give the appearance that board members are exploiting SCTs for their own benefits without providing additional value to shareholders and other stakeholders. Furthermore, SCTs should be based on long-term development. In this context, our study highlights the potential benefits of annual reviews of STIs and long-term paths via LTIs for SCT development. However, it also recognises the trade-offs and challenges, including responsiveness to technological changes, as noted by our interviewees. With a strategic combination of short-and long-term SCT implementation, companies may counteract a potential means-ends decoupling (Bromley and Powell, 2012) and provide incentives for management board members to ensure a stronger focus on sustainability strategies during a transitional phase in this regard.

According to our interviewees, supervisory boards (i.e. compensation committees) currently often still lack experience in designing meaningful SCTs. Additionally, the insufficient availability of resilient data poses a severe challenge and might explain why previous studies have found SCTs to be less accountable and reliable than financial targets (Flammer *et al.*, 2019; Haque and Ntim, 2020; Aguilera *et al.*, 2021; Ikram *et al.*, 2023). In addition, our interviewees highlight that limited data quality and a predominantly qualitative design of SCTs increase the risk of greenwashing, supporting previous work (Siano *et al.*, 2017; Bhuiyan *et al.*, 2021; Stawinoga and Velte, 2022). These implementation challenges could lead to decoupling and hinder substantial improvements of actual sustainability performance.

Our study contributes to practice and theory in manifold ways. Firstly, our results indicate that SCTs are primarily implemented owing to shareholders' demands, whereas while SCTs increasingly address broader stakeholder needs (Nigam *et al.*, 2018), a direct communication channel or systematic engagement with these groups is notably absent. If regulators aim for a stronger or more direct consideration of other (external) stakeholders' interests, it will need a different legal framework than that prevailing in the EU and stronger systematic communication channels for stakeholders. Secondly, as the depth of SCT implementation in response to external pressures varies between companies, we identify examples of decoupling as a potential additional explanation for the findings of previous studies stating that SCTs have ambiguous effects on financial success and sustainability performance. Historically, executive compensation structures focused purely on enhancing financial performance. The implementation of SCTs has introduced a variety of objectives that consider the interests of diverse stakeholder groups (Nigam *et al.*, 2018). These targets can, at times, be at odds with one another or with financial targets. As evidenced by prior research, diverging stakeholder interests may intentionally or unintentionally prompt companies to adopt practices that result in policy-practice or means-ends decoupling (Bromley and Powell, 2012; Crilly *et al.*, 2016; Roszkowska-Menkes *et al.*, 2022).

Consequently, the juxtaposition of conflicting SCTs and the strategies derived from these SCTs harbours the risk of decoupling. In this context, our findings underscore the paramount importance of ensuring that SCTs are not only transparent but also comprehensible, with a particular emphasis on the lucidity of the objectives and the alignment of the temporal horizon between these objectives and the measures that are to be derived from them. The way companies conceptualise sustainability, significantly influences their use of SCTs, ranging from a mechanism aimed at augmenting profit maximisation to a strategic tool that harmonises the pursuit of business success with the advancement of sustainability objectives. Thus, our findings offer one of the first enhanced insights into the phenomenon of decoupling within the realm of SCT implementation (Velte, 2024). Thirdly, our interview partners suggest that to ensure noticeable improvements regarding actual sustainability performance, sufficient resources are needed within a company. Simply agreeing on certain SCTs whose underlying data are not sufficiently measured and transparently communicated seems unhelpful. Fourthly, our findings add to existing studies in the context of sustainability contracting that emphasise the importance of the sustainability expertise of non-executive directors in the two-tier governance setting of supervisory boards.

Based on these insights, we stress the following research recommendations. Firstly, future studies could explain how the pressure from society, in general, affects shareholders to drive sustainability issues in companies that they are invested in. Secondly and probably most importantly, instead of using dummy variables as an indicator for sustainability-oriented executive compensation, future studies could investigate whether different implementation depths and certain SCTs have a higher or lower impact on financial and sustainability performance. In this context, it may be fruitful to investigate the extent and manner in which the adoption of SCTs at the top management level influences the integration of such measures into the target agreements with subordinate employees. Thirdly, future research could explore whether enhanced quality in sustainability and corporate governance reporting does indeed result in increased effectiveness of SCTs. Moreover, prospective research may address which accompanying (governance) measures can direct the behaviour of boards to focus on issues that contribute to the transition towards a sustainability-oriented economy. Finally, future studies can analyse whether there are differences in the implementation of SCTs between listed and unlisted companies, as unlisted European companies will also have to report on SCTs in the future due to the CSRD, without being dependent on the approval of shareholders in the context of say on pay. We hope that a promising area of future research will address these questions.

Like any scientific approach, our study is not free of limitations. Although, we carefully selected our interviewees, our findings cannot be readily construed as universally valid. Even though we have spoken to representatives of different stakeholder groups, we still only reflect a limited range. Furthermore, our interviewees originate from Germany and Austria, a setting characterised by a mandatory two-tier system with strong internal corporate governance structures, code law tradition and a strong social market economy. Therefore, studies in a different setting could result in divergent findings if the beliefs of diverse stakeholders differ greatly from those in our research setting.

Notes

1. Different terms such as environmental, social and governance (ESG) or corporate social responsibility (CSR) are used in this context. These terms interchangeably describe efforts to adopt sustainable and socially responsible policies (Rahman and Alsayegh, 2021). We aim to examine sustainability in an overarching manner. However, our interviewees referred most of the time to the concept of ESG.

2. Herein, executive compensation refers to compensation of executives of the C-level (e.g. CEO, CFO) and ordinary members of the management board. In this paper, sustainability should not only be understood as ecological sustainability, but should also include social and governance aspects.
3. Measured on the basis of the sustainability dimensions covered, their relation to financial targets, the weighting of the disclosure of SCTs in a proxy statement and whether quantitative or qualitative targets predominate within SCTs.
4. European policy guidelines of Institutional Shareholder Services at www.issgovernance.com/file/policy/active/emea/Europe-Voting-Guidelines.pdf and Glass Lewis at www.glasslewis.com/wp-content/uploads/2021/11/Europe-Voting-Guidelines-GL-2022.pdf?hsCtaTracking=ec7f46ba-dc87-455d-b1f0-99777828f9f2%7C76f3aba6-e20f-4a25-bfff-8ead257811bc
5. We would like to thank two anonymous reviewers for their extremely valuable input. The four additional interviews were conducted to better implement their comments.
6. Within the EU's regulatory framework, directives such as the Corporate Sustainability Reporting Directive (CSRD) (European Parliament and Council of the European Union, 2022), Second Shareholder Rights Directive (European Parliament and Council of the European Union, 2017) as part of the European Green Deal (European Commission, 2019) encourage transparency and accountability while also requiring companies in Germany and Austria to disclose if and how executive compensation aligns with broader sustainability strategies. Moreover, an earlier version of the sustainable due diligence directive on Corporate Social Due Diligence (CSDDD) also stipulated in Article 15 that companies should ensure that variable remuneration systems are linked to the long-term interests and sustainability of the company (European Commission, 2022). However, the version cannot find political consensus and after adoption, the final version of the CSDDD that got ratified by the member states does not contain this stipulation regarding sustainable executive compensation (Council of the European Union, 2024).

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