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Value creation and executive pay

This paper is sponsored by:

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The objective of the Forum is to serve as a platform for dissemination of guidance to remuneration committee members. Such guidance will typically cover the following:

- **Matters that relate to the function, duties and composition of remuneration committees; and**
- **Matters concerning remuneration committees in the public domain.**

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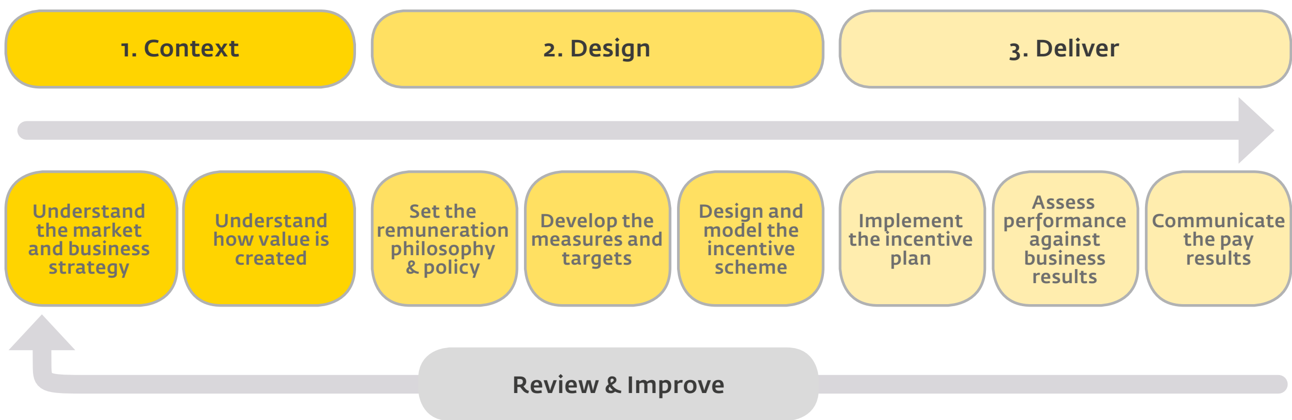
Introduction and purpose

A key responsibility of the board of directors is to oversee the creation of value for stakeholders. This responsibility gives rise to the following questions:

- What is "value", in the context of a specific organisation, and how is it defined and measured?
- What are the drivers of value?
- Over what timeframe should value be measured?
- How should remuneration be linked to value? Should executive variable pay be linked to value outcomes or to the drivers of value or both and what are the implications of these choices?

The context for these questions is given in the following diagram from the IoDSA's Remuneration Committee Forum Position Paper 4 "Linking Pay with Performance"[1]:

The 'strategy-remuneration' chain



The purpose of Position Paper 5 is to build on Position Paper 4 by providing practical guidance on "Understanding how value is created" (the second block in the diagram above), with specific reference to the questions above.

1. A copy of which can be accessed via http://c.ymcdn.com/sites/www.iodsa.co.za/resource/collection/57F28684-0FFA-4C46-9AD9-EBE3A3DFB101/Paper_4_Linking_pay_with_performance.pdf.

The Problem

Executive pay is one of the most visible and criticised aspects of corporate governance. It is discussed at the highest government levels and is the subject of articles and research by influential writers, think-tanks and consultants. New laws, regulations and policy guidelines are constantly being introduced to stem so-called "excessive" pay for executives.

Many commentators feel that the problem is not so much high pay *per se*, but rather the perceived opaque relationship between executive pay and organisational performance. The former Secretary of Business, Innovation and Skills (BIS) in the UK stated: "I am intensely relaxed about generous returns for entrepreneurs and outstanding executives but not for reward for failure". In the BIS discussion paper on Executive Remuneration released in September 2011, the problem was expressed as follows: "While CEO remuneration in the UK's largest companies has risen rapidly in the last decade, the link between pay and performance is hard to discern. The median total remuneration of FTSE100 CEOs rose annually by 13.6% on average between 1999 and 2010. By comparison, an average annual increase of 1.7% in the FTSE index was observed across the same period". This was the BIS rationale for granting shareholders a binding vote on pay policy in listed companies in the UK, following the trend in other countries.

The chief concern, therefore, is how to link executive pay more tightly to performance. Many organisations already link executive pay to clearly defined performance metrics. However, on closer scrutiny, "performance" is often defined as short term financial performance and the drivers of future or long term sustainable value are ignored.

The following statements by leading commentators illustrate the problem:

- "Compensation Committees devote great time and effort to determining how much executives should be paid, from assembling peer groups and conducting comprehensive benchmarking studies to determining the mix of cash/equity, short term/ long-term and fixed/variable pay. In contrast, many companies give too little consideration to picking the right incentive measures and periods for their specific company" (Pearl Meyer and Partners, Compensation Committee Agenda 2013);
- "Showing how pay aligns with a narrow set of key performance indicators (KPIs) has become a higher priority than making sure the metrics are relevant to the organisation's health" (Harvard Business Review, December 2014);
- "The current push to justify CEO compensation stems from short-sighted governance. If boards don't start thinking more broadly about how to track performance — measuring a range of outcomes, both for today and the future — they'll continue to face harsh criticism for being weak and for short-changing their organisations. And executive pay will keep skyrocketing" (Harvard Business Review, December 2014);
- "The vast majority of companies in corporate America dedicate significant resources to developing and executing a business strategy that is customised to their business and focused on driving and sustaining long-term enterprise value creation. Yet when it comes to aligning compensation with those distinct and company-specific business objectives, all too often companies default to "one-size-fits-all" executive pay programmes. In doing so, they fail to leverage the power of incentives to signal the importance of key strategic imperatives internally and externally, thus imperilling their ability to deliver on their stated business and leadership strategies" (National Association of Corporate Directors (NACD) and Pearl Meyer, Governance Challenges – 2014 and Beyond, 6 March 2014); and
- "Boards should link compensation to the fundamental drivers of long-term value, such as innovation and efficiency, not just to share price" (McKinsey: "Capitalism for the long term" HBR March 2011).

The above suggests that in the pay-for-performance debate, the problem lies more with what constitutes performance than with pay.

Remuneration governance principles

King III provides guidance on the subjects of value creation and pay-for-performance in:

- Principle 2.1 (para 3): "The board's paramount responsibility is the positive performance of the company in creating value. In doing so, it should appropriately consider the legitimate interests and expectations of all its stakeholders";
- Principle 2.25 (para 147): "Companies should adopt remuneration policies and practices for executives that create value for the company over the long term";
- Principle 2.25 (para 160): "Multiple performance measures should be used to avoid manipulation of results or poor business decisions"; and
- Practice Note[2] 147.4: "The company should indicate in the Remuneration Report the manner in which executive remuneration is related to the value created for shareholders and other stakeholders".

The draft King IV principle on Remuneration Governance states: "The board should ensure that the company remunerates fairly, responsibly and in a transparent manner that promotes the creation of value by the company in a sustainable manner".

Performance, therefore, should be taken to mean **short and long term value creation** for all stakeholders. It is thus the responsibility of the board, assisted by the remuneration committee, to:

- Understand performance: Define performance in terms of value creation outcomes for all stakeholders and reconcile conflicts of interest in this regard;
- Define value drivers and develop metrics for them so that they can be measured and managed;
- Linking pay: Link short and long term variable pay to an appropriate mix of these outcomes and drivers and to the extent to which they are achieved.

The International Integrated Reporting Council (IIRC) notes that there is no set definition for short, medium and long term. These are decided by each organisation with reference to its business and investment cycles, its strategies and its key stakeholders' legitimate needs and interests. To illustrate, the development of a new mine or power station would have an investment cycle of many years, whereas the introduction of a new product by a supermarket chain would have a relatively short term investment cycle.

2. http://c.ymcdn.com/sites/www.iodsa.co.za/resource/collection/24CB4885-33FA-4D34-BB84-E559E336FF4E/King_III_Remuneration_practice_note_April_2013.pdf

Understanding value creation

It is the board's responsibility to oversee the development and implementation of a strategy to create value in the short, medium and long term. Objectives should be defined so that value created can be monitored and managed on a continuous basis.

Value creation objectives and measures can be developed for both **outcomes** and **drivers**. Once the desired outcomes have been agreed, the drivers can be established through a **value driver analysis**.

Outcomes

Outcomes are the results of previous actions and typically represent value already created or destroyed. They are "lag" metrics. An organisation cannot act directly on these outcomes but rather has to act on the drivers of these outcomes. To illustrate, if an organisation has an objective to improve customer satisfaction (an outcome), it may decide the best way to achieve this is by improving response times, call centre efficiency and its goods returns policy (drivers).

Examples of value outcomes and measures for different kinds of organisations are given below:

- For-profit company:
  - Outcome: The increase in the value of the organisation over time;
  - Measures: Value can be measured by various methods including TSR, discounted cash flow (DCF), earnings multiples or residual income;
- State Owned Enterprise (SOE):
  - Outcome: SOEs do not have profit maximisation or the creation of wealth for their owners as their primary objective. Their purpose, using ESKOM as an example, is "to provide electricity in an efficient and sustainable manner. Eskom is a strategic contributor to the South African government's goal of security of electricity supply in the country as well as economic growth and prosperity"[3] ;
  - Measures: Outcome measures should reflect the extent to which the organisation's purpose or mandate is being achieved. For ESKOM, this would include the cost of electricity and the reliability of its supply, the degree to which ESKOM is self funding and ESKOM's contribution to South Africa's economic growth. These would typically be determined through an impact assessment;
- School:
  - Outcome: A typical mission statement of a school reads as follows: "To provide a dynamic and progressive education for boys that respects individual needs and embraces diversity and change in pursuit of academic, sporting and cultural excellence while providing social and leadership skills and nurturing spiritual growth"[4] ;
  - Measures: The success of the school is best measured in the eyes of its two primary stakeholders – current and future pupils (who attend the school) and current and future parents (who pay the fees). A full school and an over-subscribed waiting list would indicate that the school is providing value to pupils and parents who continue to support the school through their attendance and payment of fees.

Value is an outcome, the result of actions taken in the past. To understand how value will be created in the future, one must look at the value drivers.

3. http://www.eskom.co.za/OurCompany/CompanyInformation/Pages/Business_Vision.aspx
4. http://www.michaelhouse.org/about/values-mission-and-vision-statement/

Value drivers

value drivers are variables, or key performance indicators, that create value. They are "lead" metrics. For example, faster response times and improved call centre efficiency are drivers of customer satisfaction. Value driver analysis is the process through which outcomes are broken down into their contributing factors or drivers. Typical value drivers include customer service, talent development, succession planning, leadership development, innovation, environmental care, care for communities and social upliftment, cost control and inventory management.

It is important that value driver analysis identifies the **key** drivers, those that have a significant impact on the desired outcomes. The value drivers should also be **controllable** by the organisation so that they can be actively managed. To illustrate, even though the price of petrol will contribute to customer satisfaction for vehicle owners, it may not be a key value driver for a petrol station because it is largely beyond their control.

Value driver analysis is discussed in detail in the Appendix.

Should performance objectives be based on outcomes or drivers?

Many organisations design their incentive schemes around the achievement of outcomes, particularly financial outcomes, such as TSR or earnings per share (EPS). Over-reliance on outcome measures can lead to the following problems:

- **Outcomes can be manipulated.** They can be achieved in good and bad ways:
  - Short term profits, for example, can be increased through improvements in productivity and service, which is good, or through the indiscriminate cutting of costs such as research and development, training or maintenance, which is bad. The former will result in sustainable value creation, the latter not;
  - Similarly, sales can be "bought" by offering customers extended credit terms, same day deliveries or holding excessive inventories to guard against stock-outs, all of which could diminish the value created by the additional sales over the long term;
- **Poor line of sight.** Without a clear understanding of the drivers, the line of sight between outcomes and the management actions required to achieve them can be poor;
- **No early indication.** Outcome measures, being an end result, do not always provide an early indication that the strategy is being implemented successfully. It can be difficult to build a performance management system around outcome measures without a clear understanding of the drivers and aligning the jobs of all employees to these drivers;
- **Difficult to communicate.** Outcomes may not help management communicate the strategy to the organisation. If used, they should be in the context of a specific business objective which can be communicated from a broad perspective.

For the above reasons, objectives should be based on a balance of outcomes and drivers. This will ensure that executives are paid not only for value already created, but also for their performance in creating future value.

Timeframe for value creation

The requirement that value should be created in the short, medium and long term can lead to apparent conflicts. Investments in employee skills, marketing and research and development, for example, will result in lower profits in the short term but should, if well-conceived and implemented, grow profits in the longer term. In the case of such conflicts, organisations should default towards longer term value, even if this appears to be at the expense of short term value. Such an approach will require effective communication with key stakeholders to ensure that they understand and buy-in to the strategy.

Commentary on TSR as an incentive metric

TSR is a commonly used incentive metric in listed companies. However, despite being the ultimate indicator of value creation, it is an investor metric rather than an incentive metric and suffers from the following shortcomings:

- "Defaulting to TSR as a cornerstone metric for measuring executive performance is a missed opportunity to employ driver based incentive metrics that can motivate the attainment of key objectives that, in turn, lead to shareholder value creation" (NACD: Governance Challenges 2014 and Beyond);
- "On balance, there is no evidence that using TSR as an incentive plan metric leads to increased firm performance" (Pearl Meyer and Cornell University in their 2015 research report "The Myth and Reality of TSR as an Incentive Metric").

The preferred approach is for the board to understand the organisation's business objectives, long term strategy and the company's path to value creation and ensure these are reflected in the remuneration plan for executives.

It is suggested that TSR should still be retained as an incentive metric, but not as the predominant or sole measure, as is the case with approximately 15% of the S&P 500 companies studied by the Institute of Compensation Studies at Cornell University and Pearl Meyer (December 2015).

Summary and conclusion

The board should play a prominent role in the strategy development process. It should approve the short and long term strategies of the business and monitor their implementation by management. It therefore has a duty to understand and document the value creation process – how value is defined and measured and what drives it.

The board, assisted by the remuneration committee, should ensure that pay for executives is linked to the creation of value for stakeholders over the long term. This process is summarised in the diagram below:

The remuneration committee, in the remuneration report, should disclose the short and long term performance targets upon which executive pay is based, why these were chosen and how their satisfaction translates into payment.

The remuneration committee should always retain a degree of **discretion** over executive pay. It is not possible to reduce every element of organisational strategy and individual performance to a set of numbers and equations. The targets, measures and context that were appropriate at the beginning of a year may prove to be less relevant at the end of the year and resorting to a mechanistic calculation of executive pay may produce undesirable results. A recent example of this concerned the bonus payment to the CEO of BP (Financial Times Weekend – 16/17 April 2016). BP's remuneration committee awarded the CEO a $19.6m bonus, 20% up on the previous year, despite the company making a $5.2bn loss. Nearly 60% of shareholders voted against the award and one of them commented: "She (the remuneration committee chairperson) stuck by the letter of the rules on pay and should have shown more initiative in preventing the size of the pay package that the CEO received. Sometimes, as Remco Chair, you need to look at the big picture". Another commentator said: "When a company makes such a big loss, everyone should share the pain. Shareholders have seen their holdings plunge by 25% and dividends held flat. 7000 job cuts are looming over the next two years. Saying that the CEO should be immune because he met other targets only reinforces populist suspicions that CEO bonus plans are designed to pay out at all times".

Appendix: Value driver analysis

Value drivers will differ from one organisation to the next but the process for identifying them is similar. Some commonly used tools and techniques to help management identify value drivers in the context of their specific organisation are Stakeholder Analysis, the Balanced Scorecard and the Six Capitals Model. These are discussed in turn below.

Stakeholder analysis

The International Integrated Reporting Framework (IIRF) states: "The ability of an organisation to create value for itself is linked to the value it creates for others". Thus, when an organisation creates value for its stakeholders, which include customers, employees, investors and others, they reward the organisation with repeat business, dedicated service and the provision of funds.

Most large listed companies spend significant time identifying their key stakeholders, understanding their material interests and expectations and agreeing how best to respond to them. The process is illustrated below:

Stakeholders	Value for them	Value for your organisation
Customers	Quality products and services; fair prices; correct labelling	Repeat business and revenue growth
Employees	Fair pay; interesting work; growth & development; equal treatment; health & safety	Engaged, motivated employees; ability to attract, retain key skills
Communities	Employment/business opportunities; environment care; local hires; resource use	Reputation; brand value; trust; access to business opportunities
Government	Pay taxes; support job creation and other strategic initiatives	Favourable legislation, less interference
Suppliers	Fair allocation of business; pay on time; zero corruption	Good service; commitment
Owners	Growth, dividends, return on investment and reduced risk	Supply of capital at acceptable price

Stakeholders' interests and expectations are established through formal and informal interactions, including focus groups, workshops, surveys, and roadshows. The most material of these interests and expectations will inform the organisation's strategy. Objectives, measures and targets are developed and progress monitored and managed. Feedback is then provided to stakeholders through the organisation's annual integrated report and other channels.

The importance of stakeholder analysis cannot be over-emphasised. Employee engagement, for example, is a major driver of business performance. Highly engaged employees yield measureable business benefits such as enhanced customer loyalty, profitability and productivity and reduced employee turnover, accidents, absenteeism and merchandise shrinkage. Typical categories of employee engagement include remuneration, career and development opportunities, ethics, manager quality, work life balance, and promotion opportunities. Progressive organisations invest considerable time understanding how their employees feel about these issues. The causes of disengagement are analysed and plans are developed and implemented to ensure that gaps are addressed. These could be used in the determination of an executive's bonus.

Balanced scorecard

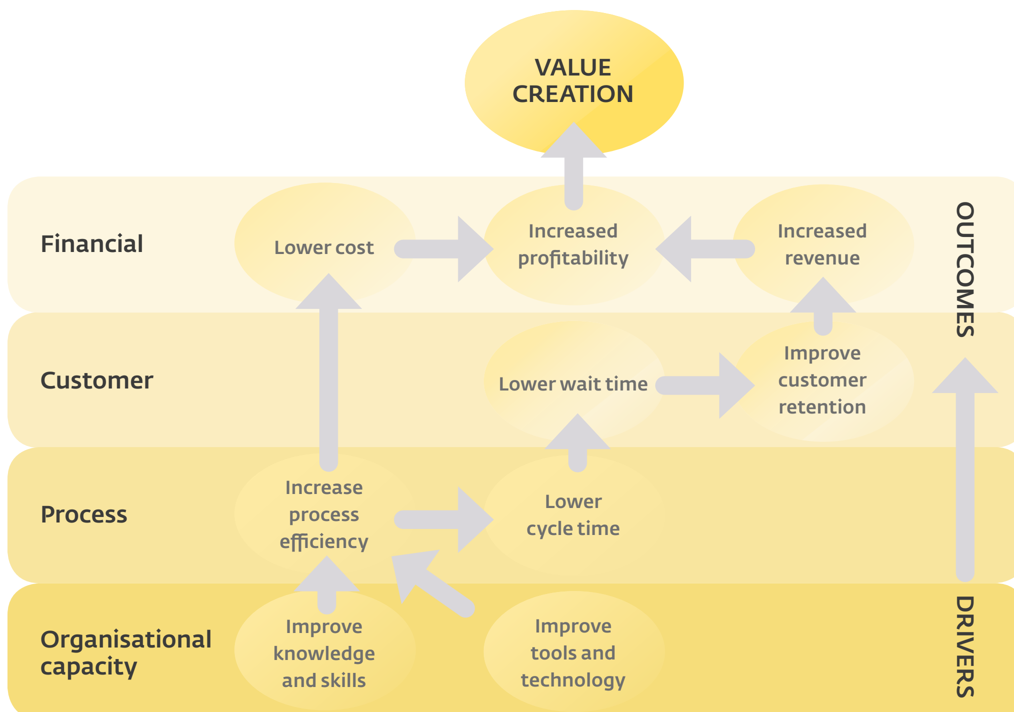
The Balanced Scorecard approach starts by defining the value to be delivered by the organisation and how it will be measured. It then identifies the value drivers through a systematic cause-and-effect methodology. The value drivers are categorised into four perspectives – financial, customer, process and organisational capacity. Taken together, the outcomes and drivers tell the story of the organisation's strategy.

For a for-profit company, where the outcome is to increase the value of the company over time, examples of value drivers are as follows:

- **Financial:** What financial criteria must be achieved to realise the value creation outcome? This could be expressed in terms of revenue growth, profitability and return on capital. Each of these could have sub-drivers. For example, revenue growth could be organic or come from acquisitions or geographic expansion;
- **Customer:** The organisation clarifies its target market/s and the products and services that will be provided to each of them. Service and quality requirements are clearly defined as these will be the basis for customer retention and revenue growth;
- **Processes:** The organisation will determine which processes it has to excel at in order to achieve its financial and customer objectives. These processes include procurement, production, innovation, customer service management, environmental care and corporate social responsibility;
- **Organisational capacity:** The organisation will establish the skills, knowledge and leadership competencies it needs to be able to deliver its strategy.

Once the key drivers of value have been identified, objectives, measures and targets are set and progress monitored. For example, to achieve a return on capital outcome, objectives for asset utilisation and the management of debtors and inventories should be developed. For revenue growth, objectives should be set for customer service to ensure customer retention and growth of the customer base.

The cause and effect relationship between drivers and outcomes is illustrated in the diagram below[5]:



The narrative in the above diagram is as follows: employees, armed with the right skills and knowledge and provided with the appropriate tools, will be better equipped to improve the efficiency of processes. More efficient processes will, in turn, yield greater customer satisfaction and reduced costs which will translate into increased revenue and lower costs and ultimately increased profitability and value.

5. This diagram is an adaptation of the diagram designed by The Balanced Scorecard Institute, in The Institute Way: Simplify Strategic Planning & Management with the Balanced Scorecard http://balancedscorecard.org/Resources/About-the-Balanced-Scorecard

The Six Capitals approach

Until fairly recently, annual reporting by companies was mostly concerned with the use and creation of financial capital - its ability to produce returns for owners. However, it is often the use of the other forms of capital that reflect how a company is able to produce value in the future. The incorporation of all forms of capital in the value creation process is referred to generally as "integrated thinking".

In December 2013, the International Integrated Reporting Council (IIRC) published its International Integrated Reporting Framework (IIRF). This framework guides organisations on reporting to stakeholders how it creates value over the short, medium and long term[6] .

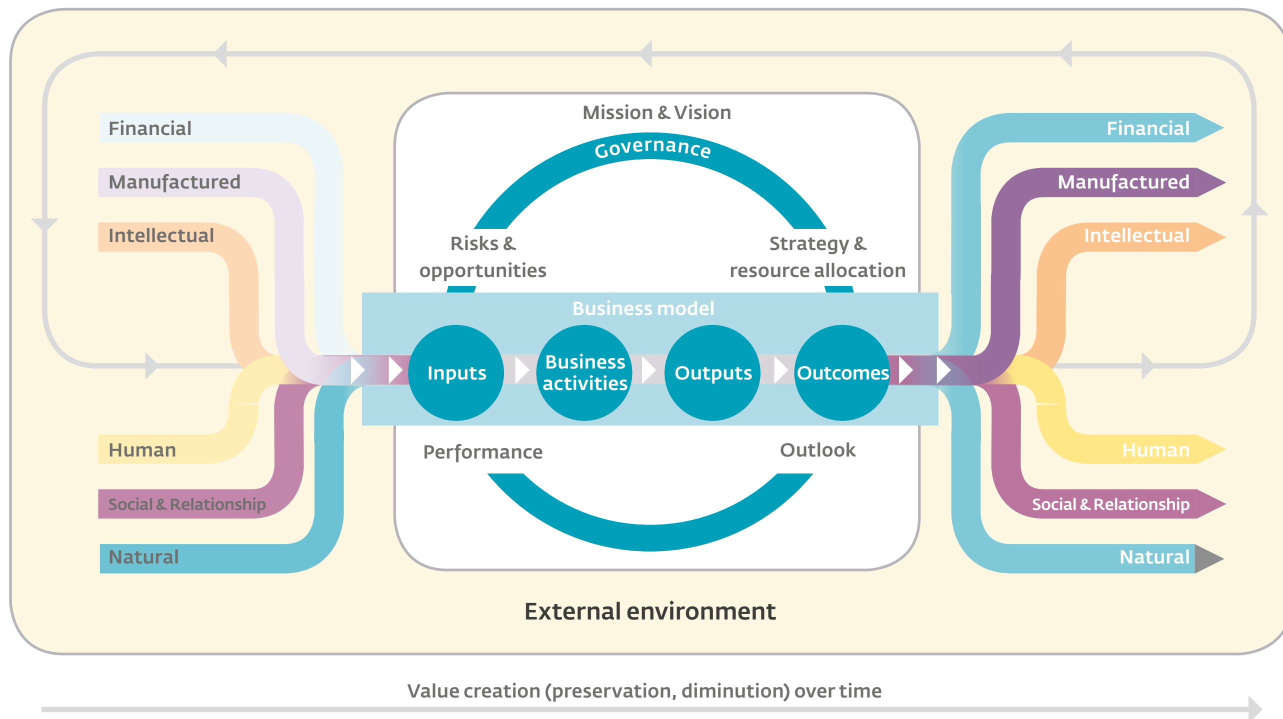
In 2015, The South African Institute of Chartered Accountants (SAICA) canvassed senior executives and non-executive directors to understand if organisations were benefiting from the adoption of integrated reporting and, in particular, the implementation of integrated thinking. The survey showed, overwhelmingly, that both executive and non-executive directors felt that their organisations had benefited. Most respondents, however, felt it was a process that takes time to reach maturity[7].

In integrated thinking, use is made of the Six Capitals model. The six capitals are:

- **Financial capital** – The pool of funds that is available to an organisation for use in the production of goods or the provision of services;
- **Manufactured capital** – Manufactured physical objects (as distinct from natural physical objects) that are available to an organisation for use in the production of goods or the provision of services, including buildings, equipment and infrastructure;
- **Intellectual capital** – Organisational, knowledge-based intangibles, including intellectual property (such as copyrights) and organisational capital such as knowledge, systems and procedures;
- **Human capital** – People's competencies, capabilities and experience, and their motivations to innovate;
- **Social and relationship capital** – The institutions and the relationships within and between communities, groups of stakeholders and other networks, and the ability to share information to enhance individual and collective well-being;
- **Natural capital** – All renewable and non-renewable environmental resources and processes that provide goods or services that support the past, current or future prosperity of an organisation. It includes air, water, land, minerals, forests, biodiversity and eco-system health.

6. http://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf
7. https://www.saica.co.za/Portals/0/Technical/Sustainability/SAICAIntegratedThinkingLandscape.pdf

The degree to which an organisation depletes or adds to the six capitals in the course of its business operations represents the value it creates or destroys. This is illustrated below[8]:



Examples of how organisations create value are as follows:

- Adding to human capital by developing the skills and expertise of their employees and value chain partners (suppliers and customers);
- Minimising the use or destruction of natural resources by recycling glass, metal, paper and plastics or by reducing water usage or limiting carbon emissions;
- Creating financial capital through the payment of taxes, dividends, bursaries and salaries; and
- Adding to social capital by supporting community health and education initiatives or by creating informal jobs in the community through, for example, waste collection initiatives or community projects.

Reporting value creation in terms of the six capitals is referred to as "integrated reporting" and goes far further than simple financial reporting.

Organisations will analyse their impact in terms of these six capitals. They will set objectives, measures and targets for each of these. For example, beverage companies typically have objectives and targets on minimising the amount of water used per litre of product produced. Similarly, consultancies will seek to increase their stock of intellectual capital through the development of processes, know-how and employee skills.

8. This diagram is an adaptation of the value creation process diagram designed by The International Integrated Reporting Council (IIRC), in The International <IR> Framework http://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf

Notes