INSTITUTE OF DIRECTORS
SOUTHERN AFRICA

Remuneration Committee Forum

Position Paper 7

Paying for sustainable performance

This paper is sponsored by:

EY
Building a better working world

The Remuneration Committee Forum (the "Forum") is constituted as a forum of the Institute of Directors in Southern Africa ("IoDSA"), and is sponsored by EY. The activities of the Forum have specific focus on the governance, accountability, role and duties of remuneration committee members.

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.**

The dissemination of such guidance will typically take the form of position papers and roundtable discussions. The current members of the Forum are:

Member	Affiliation
Mr R Harraway	Chairman, Independent
Mr T Anderson	Independent
Mr C Blair	21st Century
Mr D Couldridge	Investec
Ms J Dixon	IoDSA (Secretariat)
Mr L Grubb	South African Reward Association (SARA)
Mrs J Henstock	EY
Mr M Hopkins	PwC
Mr A Johnston	Independent
Mr P Koornhof	Allan Gray
Ms P Natesan	IoDSA
Dr R Nienaber	Independent
Mr B Olivier	Vasdex
Mr M Pannell	Korn Ferry
Mrs A Ramalho	Independent
Mr C Schaefer	EY
Ms S Tosh	Standard Bank
Ms V Vandayar	IoDSA
Mr M Westcott	PE Corporate Services

This position paper is compiled from the discussions of the Remuneration Committee Forum ("Forum") working group comprising remuneration committee members and experienced remuneration advisors. The information contained in the position papers disseminated by the Forum is of a general nature and is not intended to address the circumstances of any particular individual or entity. The views and opinions of the Forum do not necessarily represent the views and opinions of the sponsor, EY, the Institute of Directors in Southern Africa and/or individual members. Although every endeavour is made to provide accurate and timely information, there can be no guarantee that such information is complete or accurate as of the date it is received or that it will continue to be accurate in the future. No reliance should be placed on these guidelines, nor should any action be taken without first obtaining appropriate professional advice. The Forum shall not be liable for any loss or damage, whether direct, indirect, consequential or otherwise which may be suffered, arising from any cause in connection with anything done or not done pursuant to the information presented herein. Copyright rests with the Forum, and extracts of this paper may be reproduced with acknowledgements to the Forum.

First release date of paper: July 2018

Contents

Introduction 4
Sustainable behaviours 4
The 'strategy – remuneration' gap 5
Linking executive pay to strategy 6
Step 1: Define the value outcomes 6
Step 2: Develop the strategy 7
Step 3: Link to executive remuneration 9
Final thoughts 10

Appendix 1: The six capitals 11
Appendix 2: Changing legislation and corporate governance codes 12
Appendix 3: Examples of performance measures for outcomes and drivers . . 13

Introduction

This position paper builds on two previous position papers issued by this Forum:

- Paper 4, "*Linking pay with performance*", August 2015. This paper discussed the concepts of performance-based pay and value creation, introduced the 'strategy-remuneration chain' and outlined some of the various trade-off decisions a Remuneration Committee typically faces when dealing with these concepts; and

- Paper 5, "*Value Creation and Executive Pay*", June 2016. This paper extended the discussion on value creation, how executive pay should be linked to it and provided techniques for value driver analysis. This paper made a pertinent point that "...in the pay-for-performance debate, the problem lies more with what constitutes performance than with pay".

The purpose of this paper is to expand on these concepts, with a focus on sustainable pay practices. Remuneration is a tool that should be used to manage and reward executives for the successful execution of the strategy and for the creation of value over the short, medium and long term. Choosing the right basket of performance measures to monitor and assess sustainable performance, which in turn informs remuneration outcomes, remains a critical and challenging task for management and the board of directors ('the Board").

Sustainable behaviours

There is ample evidence that running an organisation for short term financial gain or for the sole benefit of shareholders will undermine its sustainability and harm the interests of other stakeholders: employees, customers, suppliers, communities and others.

Management decisions and behaviours that are short-term biased and unduly weighted towards financial outcomes are evidenced by the following examples:

- *Under-investing in research and development, training, maintenance or recruitment.* Examples are BP, which cut back on essential oil rig maintenance to reduce costs and boost short-term profits and Nike, which exploited suppliers to reduce manufacturing costs;

- *Engaging in unethical behaviours or excessive risk-taking to increase sales.* Examples are VW, which falsified engine emissions to sell more cars, and Wells Fargo Bank, which created fictitious customer accounts and transactions to achieve unrealistic sales and profit targets;

- *Using excessive amounts of retained earnings and taking on debt, to buy back shares* to meet earnings-per-share targets;

- *Linking executives' incentives exclusively to financial measures;* and

- *Over-emphasising short term financial results* at the expense of longer term performance and sustainability.

Boards have a responsibility to ensure that their companies' incentive schemes are designed to promote behaviours that create value in a sustainable manner. The Board should ensure that:

- The company's business strategy is focused on the short, medium and longer term;

- The business strategy considers all sources of value, including the six capitals and social, environmental and economic factors (inclusive capitalism) for holistic value creation. Details on the six capitals model are given in Appendix 1;

- The strategy considers the legitimate needs and expectations of all material stakeholders who have an interest in the long-term sustainability of the organisation;

- Incentives are linked to a basket of performance measures that are underpinned by the strategy.

- Both the 'quality of the performance' as well as the 'quantity of performance' are factored in to the remuneration design.

Corporate governance codes and legislation in many countries, including South Africa, have been amended or are being reviewed to address these issues. Appendix 2 contains a discussion on some of these changes.

The 'strategy – remuneration' gap

A review of the integrated reports of a number of JSE top-thirty companies reveals that gaps exist between the performance measures used in their strategies and those in their incentive schemes. One mining company, for example, lists energy and water consumption, CO_2 emissions, workforce diversity and socio-political factors as key to creating value over the longer term. However, the measures in the incentive schemes are almost exclusively financial, namely, cost management, growth in earnings-per-share (EPS) and total shareholder return (TSR). This creates the impression that the executives are being asked to do one thing but are being paid to do something else.

Financial performance alone is an incomplete assessment of performance. If the above 'non-financial' metrics are key to the creation of long-term value for the organisation, then they should be included as performance measures in the incentive schemes.

Very often, these gaps between strategy and remuneration exist because remuneration policies and metrics are designed to first and foremost conform to industry benchmarks. Instead of identifying metrics that are unique and relevant to their organisation's specific circumstances, boards and remuneration committees often default to boilerplate solutions. This may also undermine the organisation's ability to create value over the short, medium and long term. The extent of this problem is illustrated by an article in the Harvard Business Review which stated: "From 2006 to 2014, nearly all of the top 1000 largest US firms by market cap completely changed the metrics in their CEOs' pay-for-performance contracts at least once, and almost 60% changed them more than once. In some cases, of course, the revisions reflected shifts in strategic imperatives, but in many others they were attempts to fix problems that the metrics themselves had created" [1].

1 "Comp Targets that work" Harvard Business Review September-October 2017

Linking executive pay to strategy

The strategy should contain measures that enable stakeholders to monitor the organisation's performance over time. The most important of these measures should be included in the executives' incentive schemes, thus creating a clear link between the organisation's business strategy and its remuneration strategy.

A three step process for linking variable remuneration to value outcomes is discussed below:

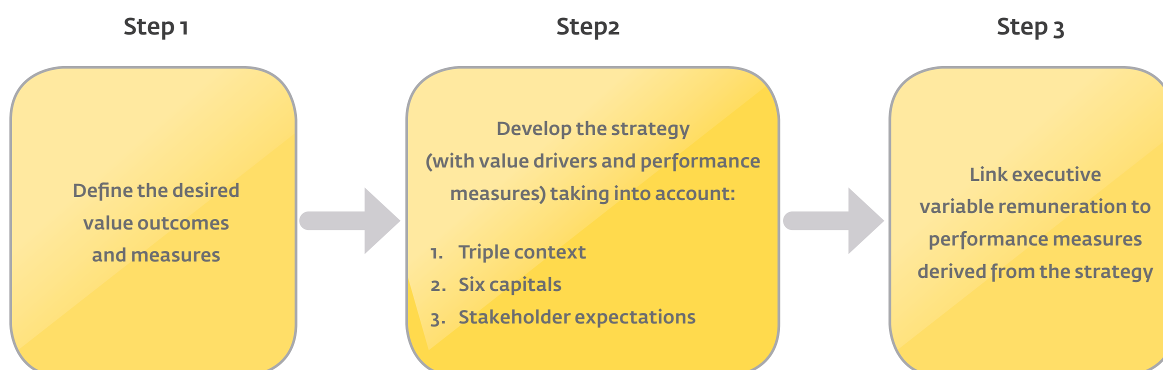

Figure 1: A 3-step process to link pay with strategy

Step 1: Define the value outcomes

All organisations should aim to create value sustainably over the short, medium and long term. The definition of such value will necessarily differ from one organisation to the next, depending on its purpose.

A for-profit company, for example, will typically aim to increase its value over time. An example of the value creation objective of a top thirty JSE company is as follows: "Our definition of victory is to grow shareholder value sustainably". This objective may seem to favour shareholders at the expense of other stakeholders. The key question, however, is how will the result be achieved? An inspection of this company's integrated report shows that the company took account of the triple context in which it operates, its impact on the six capitals and the degree to which it satisfied the needs and expectations of material stakeholders in the pursuit of its long term financial objective. These factors were included in the company's strategy and appropriate performance measures developed. This approach is consistent with that recommended by the International Integrated Reporting Council (IIRC) in its Integrated Reporting Framework: *"Long-term financial performance depends on the efficient and productive management of resources not currently measured by traditional accounting methodologies – human, intellectual, social and relationship, and natural capitals. The financial capital market is insufficient to guard against the multi-faceted and interconnected risks of the future and hence an inclusive market system should be adopted".*

A non-profit organisation or state-owned entity will typically have as its objective the fulfilment of its mandate, which may focus on specified health, education, security, or poverty relief outcomes or the delivery of other social goods or services.

A further discussion on value outcomes and related measures can be found in the Remuneration Committee Forum Position Paper 5 [2].

2 Remuneration Committee Forum Position Paper 5 – June 2016 "Value Creation and Executive Pay" accessible https://www.iodsa.co.za/page/ForumRCF

Step 2: Develop the strategy

Having clarified its value outcomes, the organisation should develop a strategy to achieve them. Key to this is identifying the value drivers – those activities which, if properly implemented, will produce the desired value outcomes.

Typical value drivers include: managing costs, improving asset productivity, developing new products, improving customer service, developing human capital capability, improving production efficiencies, minimising negative impacts on the environment, developing mutually beneficial relationships with stakeholders, developing entrepreneurs in the supply chain, maintaining a good standing with regulators, effectively managing risk, broadening the gender and race diversity of management, improving employee morale, improving safety processes and practices and improving corporate governance.

In addition to driving long term value outcomes, these activities are often desired outcomes in their own right.
For example, if it is believed that responsible water usage is a key driver of long term financial performance, as it is in organisations such as SAB Miller and Coca Cola (refer to foot note 3 below), then an objective to achieve an agreed level of water efficiency would be included in the organisation's strategy and incentive schemes.

Value drivers will differ from one organisation to the next, depending on their specific context. A mining company, for example, would place more emphasis on safety and environmental protection than would a consulting organisation. The cause-effect relationship between value drivers and value outcomes must be verified by individual companies.

Value drivers can be both positive and negative, and can be expressed either as outcomes in their own right or as drivers of some higher outcome. The table below provides some examples of value drivers expressed as outcomes:

Table 1: Examples of Value Drivers

POSITIVE	NEGATIVE
ECONOMIC	
Fair and responsible remuneration	Bribery and corruption
Profitability and asset productivity	Waste through inefficiency
Wealth created for stakeholders	Poor productivity
Taxes paid	Taxes evaded
Research and development	Exploitation of suppliers
SOCIAL	
Corporate social investment and BBBEE	Below living wages
Supplier diversification and development	Inadequate health care
Infrastructure development	Unsafe working conditions
Enterprise development	Unwarranted lay-offs
Contribution to skills upliftment	Inadequate staff education
ENVIRONMENTAL	
Land rehabilitation	Air and water pollution
Use of renewable energy and resources	Wasteful resource consumption
Recycling	Ecosystem degradation
Pollution management	Production of non-biodegradable waste
Water usage managed	

Building a better working world

Table 1 shows that drivers of long term financial value are often non-financial themselves. Water usage, black economic empowerment and skills development are further relevant examples of non-financial value drivers:

- *Water usage.* Water is a scarce resource in many parts of the world and water intensive businesses are under a particular obligation to manage their water usage. Failure to so do could result in the company's business licence being revoked [3]. Good water management is therefore both an environmental responsibility and a key business imperative. In South Africa, companies like Coca Cola and SABMiller have managed their processes to achieve water usage targets, expressed as litres of water used per litre of product produced.

- *Black economic empowerment.* In South Africa, a company's broad based black economic empowerment (BBBEE) rating is an influencing factor in the company's ability to access business opportunities, particularly government contracts. As with water usage, a good BBBEE rating, besides achieving broader social imperatives, is a business enabler which impacts long-term financial performance. Progressive companies set targets and actively work to improve their BBBEE status.

- *Skills development.* A skilled workforce is an important driver of business performance. Progressive companies set standards relating to employee skills and capabilities and take action to achieve them.

The most important drivers should be included in the organisation's strategy. Each should be expressed as a key performance area to be achieved, for example improved profitability or water usage managed. They should be accompanied by one or more measures, or key performance indicators, which describe how they will be measured, for example growth in earnings per share or water used per litre of product produced. Each should be weighted to reflect relative importance and levels of performance, typically at the threshold, target and stretch levels. Appendix 3 gives examples of key performance areas, key performance indicators and weightings.

Defining interim performance measures for value drivers is also important when the timeframe to achieve the final result is long. For example, in the case of the development of a new mine, a CEO who initiated the decision to develop the mine may have left the company before final commissioning of the mine. In this situation, the CEO cannot be assessed on the final results but only in terms of meeting key milestones over the duration of the approved project plan.

3 In April 2003, the Perumatty Grama Panchayat (Village Council) refused renewal of Coca-Cola's license to operate on the grounds that it was not in the public interest to renew the license stating "...the excessive exploitation of ground water by the Coca-Cola Company in Plachimada is causing acute drinking water scarcity inPerumatty Panchayat and nearby places..."

Step 3: Link to executive remuneration

The final step is to link the incentive design to the organisation's strategy. This step is emphasised in Principle 14 of KING IV™ [4]: "The Board should ensure that the organisation remunerates fairly, responsibly and transparently so as to promote the achievement of strategic objectives and positive outcomes in the short, medium and long term." As discussed earlier, in practice, this third step is often the weakest in the three step process.

Position Paper 5 [5] made the point that the "…performance measures included in the incentive schemes should be based on a balance of value outcomes and drivers. The incorporation of value drivers (lead metrics) into a company's scorecard and incentive schemes facilitates the measurement of performance during the period, unlike financial outcomes (lag metrics) which can often only be measured at the end of the period. This makes them readily manageable through the company's performance management system. Outcomes can also be manipulated by negative actions or behaviour. For example, profits can be increased through the indiscriminate cutting of costs such as research and development, training or maintenance. Furthermore, without a clear understanding of the drivers, the line of sight between outcomes and the management actions required to achieve them can often be poor."

Performance measures can often be expressed in easily quantifiable terms, such as volume or revenue growth, efficiency improvements, stock turns, vehicle utilisation or profitability.

Non-financial performance measures that are important to the business may be incorporated in the incentive scheme in their appropriate weighting (see Appendix 4), as qualifiers or modifiers, or in the individual performance contracts of the executives.

- Qualifiers, also referred to as gatekeepers, are generally conditions in an incentive plan that have to be met before a participant can receive a pay-out, regardless of his or her individual performance. Qualifiers are included in the scheme so as to help protect the business, ensuring that the company takes account of the triple context in which it operates, and its impact on the six capitals.

Qualifiers are only used to reduce the score, rating or amount, i.e. a penalty effect. Qualifiers can take many forms, such as:

- Behavioural, for example, completion of product training or adherence to administrative processes;
- Team-based, for example, individual team members can only receive a pay-out provided the team as a whole achieves a minimum level of performance;
- HR related, for example, a participant may not receive a pay-out while he or she is on a performance improvement plan;
- Safety related, for example, participants may not receive a pay-out if there is a fatal accident during the period. A further example is lost time injuries, whereby one lost time injury could result in, say, a 25% reduction in the incentive, and two lost time injuries results a 50% reduction, etc.

- Modifiers, on the other hand, act as multipliers which can either accelerate or decelerate a participant's pay-out relative to a target. For example, participants in an incentive scheme may receive enhanced or reduced pay-outs depending on the company's customer satisfaction rating or achievement of social goals.

Each executive should have a performance contract detailing his or her individual objectives. The contract should have a balance of outcome measures and drivers. These contracts provide a basis for assessing their performance that is used as input to their variable remuneration awards.

As far as possible, a portion of the variable pay awards should be deferred and only released as related longer term successes are realised. Awards should also be subject to malus and clawback provisions to help maintain the focus over a longer term.

4 King IV Report on Corporate Governance for South Africa, 2016
5 See Note 2

Final thoughts

Remuneration committees should strive to close the gap between the performance measures in the business strategy and those in the incentive schemes. This will ensure that executives are incentivised to focus on holistic value creation, as opposed to just short term profits and financial outcomes. This should result in a balanced basket of performance measures included in the incentive schemes, comprising value outcomes and value drivers, financial and non-financial, short, medium and long term. System thinking, as opposed to siloed thinking, will help achieve such a balance.

All the measures included in the basket should receive equal treatment and rigour in terms of risk assessment, and data quality assurance. The risk assessment would typically address the risk of any unintended consequences, such as encouraging high risk behaviour, market conduct risk, or damage to the organisation. Internal audit would need to play a role in providing data quality assurance, especially with the non-financial measures. The remuneration committee should call for this assurance, and monitor and assess performance regularly throughout the year and not just at year end.

The remuneration committee should seek the support of shareholders, particularly institutional shareholders, when selecting or changing performance metrics for inclusion in the basket of measures to be included in the incentive schemes.

The main performance measures, the reasons for selecting them and how they support the strategy should be disclosed in the remuneration report.

Finally, closing the remuneration-strategy gap has important implications for the skills, competence and diligence of Boards and directors of organisations. According to research carried out by McKinsey in 2013: "A mere 34% of the 772 directors surveyed in 2013 agreed that the boards on which they served fully comprehended their companies' strategies. Only 22% said their boards were completely aware of how their firms created value, and just 16% claimed that their boards had a strong understanding of the dynamics of their firms' industries". The experience, knowledge, diversity, competence and diligence of Board members are fundamental prerequisites for effective governance and sustained organisational performance.

Appendix 1: The six capitals

As noted in the IIRC's Integrated Reporting Framework, all organisations depend on various forms of capital for their success. These are classified as financial, manufactured, intellectual, human, social and relationship, and natural:

1. **Financial capital** – The pool of funds that is available to an organisation for use in the production of goods or the provision of services.

2. **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.

3. **Intellectual capital** – Organisational, knowledge-based intangibles, including intellectual property (such as copyrights) and organisational capital such as knowledge, systems and procedures.

4. **Human capital** – People's competencies, capabilities and experience, and their motivations to innovate.

5. **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.

6. **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.

The capitals are stocks of value that are increased, decreased or transformed through the activities and outputs of the organisation. For example, an organisation's financial capital is increased when it makes a profit, and the quality of its human capital is improved when employees become better trained.

Although organisations aim to create value overall, this can involve the diminution of value stored in some capitals, resulting in a net decrease to the overall stock of capitals. In many cases, whether the net effect is an increase or decrease (or neither, i.e. when value is preserved) will depend on the perspective chosen; as in the above example, employees and employers might value training differently. In this Framework, the term value creation includes instances when the overall stock of capitals is unchanged or decreased (i.e. when value is preserved or diminished).

Appendix 2: Changing legislation and corporate governance codes

Stakeholders, legislators and commentators around the world are highlighting problems with incentive schemes that promote short term interests at the expense of long term value creation. Many countries have updated their legislation and corporate governance codes to encourage Boards and executives to take a longer term and more complete view of value creation and to link executive pay more effectively to value and its drivers.

Shareholders have been given greater powers over executive remuneration and legislation is either proposed or in place to require organisations to publish and justify executive remuneration outcomes, the link to organisational performance and the wage gap. In the UK, certain categories of companies will soon be required to include non-financial measures in their Strategic Reports and explain how these drive value. It has been further proposed that the UK Corporate Governance Code that the vesting period for share awards in the UK be increased from three to a minimum of five years. The UK has recently commissioned research into the use of share buybacks to artificially hit performance targets and inflate executive pay.

In South Africa, King III™ emphasised that organisations are corporate citizens that are accountable to all material stakeholders and not just shareholders. This requires that organisations should be aware of their economic, social and environmental impact when developing and implementing their strategies to create value. The new King IV™ goes further by defining performance and value creation in terms of the organisation's impact on the triple bottom line and the six capitals as well as achievement of its strategic objectives.

Performance and value creation are multidimensional concepts which make reference to a number of desired outcomes: a) the achievement of strategic goals; b) meeting the legitimate needs and expectations of material stakeholders; c) the impacts on the six capitals; d) the impact on the triple context. Equal precedence is given to each of these. However, attempting to maximise the performance of an organisation simultaneously in multiple directions gives rise to the following practical problems:

- How should the outcomes be measured and over what period? For example, organisations often equate expenditure on training with an increase in the value of human capital. This may be too simplistic. Enhancing human capital usually requires\ that training is supplemented by exposure to opportunities, regular performance feedback, on the job coaching, clear definition of roles and supportive leadership.

- On what basis should organisations make trade-offs between their use and enhancement of the capitals? For example, does money spent to reduce the amount of CO_2 emissions (preservation of natural capital) produce more or less value than a similar investment in R&D (enhancement of intellectual capital)? Does either justify the reduction in financial capital?

- The reduction of some capitals is acceptable provided the value of other capitals increases to produce a net positive effect. To calculate this net effect, one would need a common language for measuring the impacts of an organisation's activities across each of the six capitals. It is not currently clear how this should be done.

Much of this confusion may be resolved by creating a clear link between the organisation's business strategy and its remuneration strategy. Thus, if the strategy states that the preservation of natural capital is key to creating value over the longer term, as it would be for a mining company, or that the enhancement of intellectual capital is key to creating value over the longer term, as it would be for a consulting organisation, then performance measures relating to these issues should be considered for inclusion in the incentive schemes.

Appendix 3: Examples of performance measures for outcomes and drivers

KEY PERFORMANCE AREA (KPA)	KEY PERFORMANCE INDICATOR (KPI)	WEIGHT	CURRENT LEVEL OF PERFORMANCE	TARGETS FOR THE PERIOD (Short, medium long term specified)		
				THRESHOLD	TARGET	STRETCH
ECONOMIC						
Grow shareholder returns	TSR performance relative to peer group on rolling 5 year basis	a%	50th percentile	55th		
percentile	60th percentile	65th percentile				
Grow profits	EPS growth	b%	5%	6%	7%	8%
	EBITDA growth	c%	9%	10%	11%	12%
Improve asset productivity	ROCE	d%	12%	13%	14%	15%
Manage working capital	WCR/sales	etc	20%	19%	18%	17%
SOCIAL						
Diversify supplier base	HDI suppliers as % of total		20%	21%	22%	24%
Upskill workforce	% of employees meeting skills requirements of role profile		68%	70%	73%	77%
Safe working conditions	Lost time frequency rate		0.25	0.24	0.23	0.22
Gender diversification	% women in management roles		20%	24%	26%	28%
Enhanced economic empowerment	Corporate BBBEE rating		7	6	5	4
Contribution to community health	No of community members treated in company clinics		300	320	340	350
ENVIRONMENTAL						
Minimise water usage	Total m3 per ton product		150m3/ton	145	140	135
	Recycled water as % of total		44%	47%	49%	52%
Minimise greenhouse gas emissions	Tons CO_2 equivalent / ton product		0.95tons CO_2/ ton	0.9	0.88	0.85
Reduce total energy consumption	G Joules per ton product		8.5GJ/ton	8.3	8.1	7.9

Note: All numbers are illustrative. A KPA is a statement of what the organisation wishes to achieve (for example: improved asset productivity) and a KPI states how that KPA is measured (for example: return-on-capital-employed (ROCE).

Building a better working world

Notes

Notes