10 minutes on...

Soft measures: harder than you think

March 2017

During the 2016 AGM season, some institutional investors and proxy advisers expressed opposition to the use of non-financial performance metrics in executive reward. There is reason for healthy scepticism however, we believe non-financial metrics are an integral measure of organisational and executive performance and there should be more nuanced consideration given to their use.

2016's AGM season saw a marked increase in the number of strikes against remuneration reports across the ASX 200[1]. One of the key concerns raised related to the use (and disclosure) of non-financial performance metrics.

The use of non-financial measures in executive reward is not a new thing. In the ASX 200, the use of non-financial measures has been relatively stable - with non-financial metrics typically making up between of 30% to 50% of companies' STI plan metrics. Use of non-financial metrics in LTI plans remains relatively uncommon, with only a few companies incorporating such metrics.

So why have non-financial metrics become a point of contention? Are they actually soft (for example, do we tend to see higher STI outcomes associated with non-financial measures), or is the conversation being dominated by the poor practices of a few organisations who have mismanaged non financial metrics? Has there been a growing impatience with 'soft' metrics for some time, or have shareholder expectations fundamentally changed?

Research suggests that there is value in focusing executives on non-financial measures (see page 2). But this requires the selection of metrics that have a strong impact on future performance, and careful calibration of targets. Without this focus, an opportunity may be missed to deliver future financial performance.

In practice, we have not found any relationship between higher weightings on non-financial measures and higher STI outcomes (see page 3). However, limited disclosures makes the relationship difficult to assess.

Our view is that well-defined non-financial metrics can play an important part of executive incentives. However, there is a need for greater rigour in the selection and calibration of non-financial metrics, and disclosure needs to be improved substantially - including more transparency regarding the actual measure, the performance target, and ultimately the outcome.

[1] PwC (2016), '10 minutes on... 2016 Annual General Meeting season - In whom we trust?', PwC paper

There are four main arguments against the use of non-financial measures

The correlation to shareholder value is ambiguous and difficult to evaluate

Measures describe an executive's day job and therefore do not warrant an incentive payment

There is a lack of rigour / transparency in disclosures, allowing the Board to be 'soft' when assessing performance

There is some redundancy in a non financial metric, even if it is strongly aligned with strategy, as performance should ultimately translate to financial results

Soft measures but hard impact

Studies have shown that in the right circumstances, a focus on non-financial outcomes can have a strong impact on future financial performance. Non-financial metrics are therefore an important tool for Boards to consider in focusing executives on key outcomes in the short term that will drive organisational performance over the longer term.

It seems intuitive that key areas of non-financial performance (such as customer satisfaction, leadership, staff engagement, etc) should improve financial performance. Indeed they close certain gaps that financial measures do not recognise, help managers to monitor progress against strategy execution, are often lead rather than lag indicators, and motivate employees around actions that can best deliver the strategy.

Evidence backs up the case for the inclusion of non-financial performance in incentive plans…. in the right circumstances

- Across a number of the most commonly used non-financial metrics, there is research demonstrating a 'hard' link to future organisational performance (as shown to the right).
- Furthermore, companies that have established a *causal* link between the non-financial measure and financial outcomes, have delivered significantly higher returns that companies who have not[1].
- The market undervalues intangibles[2] such as employee satisfaction.
- The benefits of such intangibles do not flow into share prices for some time[2] and so annual financial performance is insufficient to capture this.

Companies that were in the top quartile of ***employee engagement*** had 21% better profit outcomes and 20% better sales productivity, than the companies in bottom quartile[3]

21% greater profit

Customer satisfaction is a leading indicator of future financial performance - but only in some industries (e.g. those that ares service based such as telecommunications more so than mining)[4]

More ***gender diverse*** companies (those in the top quartile) were 15% more likely to have financial performance above the national industry average compared to less diverse organisations (i.e. bottom quartile)[5]

15% more likely to perform above average

86% of C-suite executives said ***culture*** is critical to their organisation's success[6]

86% say culture is critical to success

Companies with a ***strong corporate culture*** realise the benefits through ***long-term economic outperformance*** and greater return on investments[7,8]

Both APRA chairman (Wayne Byres) and the CEO of the Australian Council of Superannuation Investors (Louise Davidson) have stated their support for the inclusion of these 'soft' measures in CEO incentive plans under the right circumstances.

[1] Ittner, C. and Larcker, D. (2003), 'Coming up Short with Nonfinancial Performance', Published in the Harvard Business Review
[2] Edmans, A. (2011), 'Does the Stock market Fully Value Intangibles? Employee Satisfaction and Equity prices', Published in the Journal of Financial Economics
[3] Gallup and University of Iowa (2016), 'The relationship between engagement at work and organisational outcomes: 2016 Q12 Meta Analysis (9th Edition)'
[4] Keiningham, T., Gupta, S., Aksoy, L., Buoye, A. (2014), 'The High Price of Customer Satisfaction', MIT Sloan Management
[5] McKinsey (2015), 'Why diversity matters'
[6] Strategy& (originally published by Booz & Company) (2013), 'Culture's role in enabling organisational change'
[7] Kotter, J.P. and Heskett, J.L. (1992), 'Culture and Corporate Performance'
[8] Denison, D.R. (1984), 'Bringing corporate culture to the bottom line'

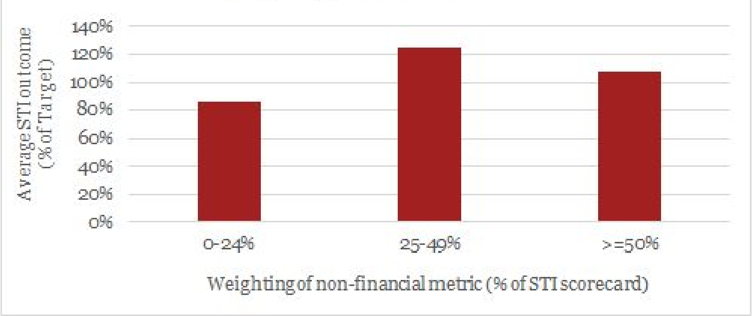
Soft measures don't necessarily mean a soft bonus outcome

We did not find any relationship between higher weightings on non-financial measures and higher STI outcomes, or less STI variability year on year. This suggests that generally non-financial measures are not as 'soft' as their reputation suggests. However, current disclosures do not allow shareholders to easily assess the resulting outcomes of their use, and should be improved.

Current disclosures make it difficult to conduct a robust assessment on the 'ease' of achieving non-financial metrics. Ideally, we would simply review the results on individual measures, and determine if, on average, non-financial measures are paid out more than financial measures. But current disclosures do not allow for this.

Instead, we have considered the weighting between financial and non-financial measures in CEO scorecards used for STI purposes, and the relationship to actual STI outcomes. That is, do STI scorecards with a higher weighting on non financial metrics lead to higher STI outcomes? We could do this for 54 companies only, as shown below.

Greater weighting of non-financial measures doesn't correlate with higher STI outcomes for ASX 100 companies[1]



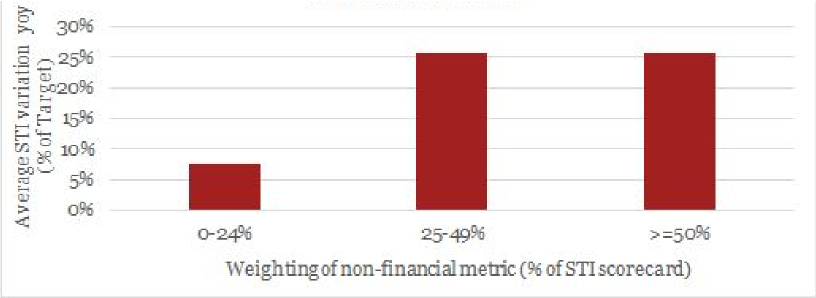
The outcomes of this analysis, shown above, shows that an increased weighting of non-financial measures does not necessarily lead to increased STI outcomes (e.g. companies with >=50% non-financial measures had lower payout levels than companies with 25-49% non-financial measures).

Given that the use of non-financial measures in LTI plans remains uncommon, we have focused on STI data only.

We have seen a reduction in the variability of STI outcomes over the last couple of years. Early analysis of FY16 data indicates that this trend is continuing. These outcomes prompt the discussion that STI outcomes are not variable and are in fact de facto base pay. Some stakeholders view this to be particularly true of non-financial metrics which they believe represents additional pay for an executive's 'day job'.

As we have already discussed, the evidence supports the inclusion of non-financial metrics where they have a strong impact on advancing strategy and hence financial performance. So do non-financial measures contribute to the 'noise' by diluting the link between pay and performance?

To provide a view on how this plays out in practice, we have considered the relationship between year-on-year STI variability for same incumbent CEO's, and the weighting on non-financial measures in CEO scorecards.



As seen, an increased weighting of non-financial measures does not lead to low variability in STI outcomes. Rather, greater variability is seen where scorecards have at least 25% weighted to non-financial measures.

This suggests that criticisms around low variability in STI outcomes should not be levelled at non-financial measures only. Rather, it appears to be a target setting issue that could apply to both financial and non-financial measures.

[1] Data obtained from CEO scorecards as disclosed in company Remuneration Reports. Companies have been excluded where their disclosures is insufficient to determine financial / non-financial nature of the metrics.

What can companies do?

It is the Board's role, with the support of the Remuneration Committee and management, to build trust in non-financial metrics. For example, by transparently communicating to shareholders the rationale behind metric selection and inclusion, the metric definition and measurement, and the resulting performance assessment and payment as it relates to an executive's performance.

In our experience, there are four common pitfalls that reduce the acceptability (and effectiveness) of non-financial measures. With these addressed, we believe that non-financial measures can be a valuable part of executive scorecards, and a company's STI and/or LTI plans, and an important lever to ultimately drive shareholder value.

Common pitfalls

Boiler plate scorecards

- Adoption of a classic balanced scorecard, or non-financial metrics that are common in the market, or simply "those that peers use'
- Limited analysis to understand the relationship of non financial value drivers to strategic goals and financial outcomes

Simplistic metrics

- Use of crude scales which lack validity and reliability (e.g. customer metrics are often focused on transactions rather than entire customer journey/ experience)
- Inconsistent methodologies across the business

Difficulty in setting stretching targets

- Outperformance is only typically valuable to a point, after which there are often diminishing or even negative returns (e.g. a study of one company found that customers who were 100% satisfied spent no more money than those who were only 80% satisfied[1])
- Unintended consequence of stretching targets (e.g. stretching goals associated with safety metrics such as incident frequency rates, can lead to under-reporting)
- Efforts may improve non-financial performance but can damage short-term financials

Poor disclosure

- *Why* - The rationale for inclusion is not often clearly articulated. It is often difficult to ascertain how the measure is aligned with long-term shareholder value creation
- *What* - Metrics and their definitions are rarely clearly articulated. Targets are rarely disclosed prospectively, and even retrospectively
- *How* - Current disclosures do not allow shareholders to adequately assess how the pay outcomes have been determined

What can companies do?

1. *Take ownership of aligning executive remuneration to organisational priorities*

   This may include conducting a value driver analysis to identify only the non financial metrics that matter, and reviewing its validity regularly (e.g. annually). Metric weightings should reflect the relative importance - don't overweight non-financial measures.

2. *Ensure that the measurement and assessment of non-financial metrics is robust and transparent*

   Invest in defining non-financial metrics and how they will be measured. Apply the same rigour as that applied to financial measures.

3. *Set stretching performance targets which will lead to real value creation*

   Set clear performance levels for each metric - including the level of performance below which no payment will be made, and stretch performance targets.

4. *Communicate to all stakeholders the importance of the metrics chosen and reasoning behind outcomes*

   Over communicate. High quality disclosures should cover a clear description of the metric and the rationale for its selection, its weighting in the scorecard, how performance is assessed and the resulting payment.

5. *Apply judgement in the assessment of non-financial metric but be prepared to explain*

   Acknowledge that a level of discretion may be required. Enable variability in outcomes year-on-year. Be prepared to honestly acknowledge that performance on a selected metric has not been met.

[1] Ittner, C. and Larcker, D. (2003), 'Coming up Short with Nonfinancial Performance', Published in the Harvard Business Review

How can PwC help?

To have a deeper discussion about these issues, please contact:

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