REWARD VALUE

Impact yardstick

A central feature of any remuneration policy is an agreement on the 'yardstick': the measure of success used to gauge the firm's performance.

Many CEOs are rewarded for mainly short-term financial targets. Yet share- and stakeholders rarely want short-term financial success if it comes at the cost of long term value. For this to change, performance yardsticks must also change.

Together with the Dutch Impact Institute Foundation, we're developing a database of firm-level social and environmental monetized impacts. This database will allow us to assess the 'net societal value added' of firms by netting financial impact with the financial value of social and environmental impacts (both positive and negative). This results in a more truthful measure of firm sustainable value creation for all stakeholders to which compensation may be tied. Once finished, this approach of monetizing firm impacts has several useful features. The direct measurement of net societal value creation spurs CEOs to act with societal interests in mind. Similarly, direct measurement implies that decompositions of financial and various aspects of non-financial value should be possible. This offers CEOs and stakeholders the tools to assess where firm behavior should be directed. Relatedly, given that all impacts are expressed in the same units of account, trade-offs between various stakeholder interests become transparent and comparable. Taken together, the role of this impact yardstick then becomes severalfold: it incentivizes the right behavior but can also be analyzed to guide strategic decisions and supports fairness in firm behavior by rationalizing the trade-offs between various stakeholder interests.

Workplan

Together with the Impact Institute Foundation, we're setting up a workplan that aims to deliver results in 2022. The approach consists of several steps:

1. Impact Institute Foundation develops a comprehensive dataset on firm-level societal and environmental impacts. The role of Reward Value here is to give input for the data collection and impact quantification methodology so that i) Reward Value understands the methodology, and ii) the resulting dataset is suitable for compensation purposes.

2. Reward Value and Impact Institute Foundation decide on and develop a methodology for relating societal and environmental value to financial performance in order to arrive at a single figure sustainable long term value creation measure.

3. Reward Value merges the resulting dataset with a dataset of other performance metrics to assess how the perspective on firm performance changes vis-à-vis currently commonly employed performance indicators.

4. Reward Value merges the resulting dataset on firm performance to compensation data to assess how current compensation outcomes relate to societal value creation, as well as to perform counterfactual analyses of how pay would change when firms would adopt pay policies that target the societal long term value creation measure.

5. Reward Value and Impact Institute Foundation jointly publish the results of this data analysis.

6. Parallel to this and if possible: Reward Value and Impact Institute engage with companies to gather feedback on the feasibility of employing the developing performance yardstick. Additionally and if possible: we will run an in-company pilot of the yardstick.

Assessing convergence in long-term outcomes

Whilst many stakeholders as well as shareholders agree that firms should focus on long-term outcomes, few offer a view on what this 'long term' is and why they feel that their view of the 'long term' is appropriate. Is 5 years the long term or 10? If it is 10, why?

In terms of compensation policy, the appropriate long-term may be the term at which different measures of firm outcomes converge. Shareholders may be willing to forego short-term cash profits in return for future gains that result from current period investments. This expectation of future profits is discounted into asset valuations, but at some point, such expectations should materialize for the foregone short-term cash profits to be worthwhile to the investor. Likewise, material non-financial issues affect future firm performance (human capital, climate risks, etc.), but it takes time for such issues to affect the firm's bottom line.

For compensation policy, the optimal long-term may be at the nexus between current and future costs and benefits for shareholders and stakeholders. A measure of CEO performance is 'fair' if it has had sufficient time to 'absorb' all relevant financial and non-financial costs and benefits. In this research project, we aim to estimate this term: how long does it take for accounting and share-based performance to align and how long does it take for non-financials to be appropriately accounted for in profits and valuations.

Workplan

The workplan for this project consists of several steps. The point of departure is to perform an update of Easton et al. (1992). That paper highlights the term over which accounting measures explain security returns. The update will shed light on the extent to which this term still holds (also: when including new estimation methods). An extension will focus on the role of ESG factors.

1. Starting from Easton et al. (1992), we'll perform a structured literature review to gain further insight into the relationship between (the convergence in) accounting performance and share returns over the long run.

2. We setup a database that allows us to measure long horizon convergence in accounting and share price performance measures. We quantify this relationship by performing regression analyses in the spirit of Easton et al. (1992).

3. We extend to database by including ESG datapoints and perform regression in the spirit of Easton et al. (1992) in order to assess a time period over which ESG outcome levels and financial performance levels start to converge.

4. We merge the dataset to compensation data in order to measure how the ‘convergence time horizon’ compares to currently employed ‘compensation time horizons’ and what that implies for realized CEO payouts. We’ll perform counterfactual simulations in order to estimate changes to CEO pay when the time horizons would align

Conviction barometer

Firms increasingly recognize that share- and stakeholders expect that firm behavior keeps societal interests in mind. As a result, firms attempt to act purposeful and to engage with stake- and shareholders on material societal interests. This engagement may be bilateral, in the public debate, at the AGMs and through disclosures. Parallel to such efforts by firms, there is a widespread concern that talk is cheap. Actual decisions may deviate from stated objectives, and many of the disclosures and other touchpoints for engagement may be heavily skewed to paint the firm in a more favorable (often: greener) light.

In partnership with the Diligent Institute (US), we're developing an AI-powered tool to assess the extent to which firm attitudes, attention and actions align. This assessment of alignment or conviction should help us to better understand whether companies focus on the right issues and whether they are able to translate their focus on the right topics into concrete actions to drive long-term societal value creation.

With respect to pay, such tracking of intentions, actions and progress is important as well. Companies should align purpose, performance and pay. Measuring the extent to which purpose is embedded in firm priorities and outlooks can facilitate monitoring and a quantification of the relation between purpose and pay. Likewise, measuring firm attitudes, attention and actions and the outside perception of those attitudes, attention and actions may serve as a proxy and/or a leading indicator for performance. 'Impact' may be a slow-moving variable. Pivoting to a green business model takes time, and the effects of that will only become apparent after an implementation lag. Until the pivot is finalized, there still is a need to track progress. The conviction barometers may be one tool to track firm attitudes, attention and actions.

Workplan

Together with the Diligent Institute, we're setting up a workplan that aims to deliver results in 2022. The approach consists of several steps:

1. Diligent Institute and Reward Value jointly develop an AI methodology that measures firm attitudes, attention and actions with respect to ESG outcomes. The approach relies on applying a text processing AI to company filings (annual reports and sustainability reports). The resulting data are indicators of company attitudes, attention and actions with respect to ESG outcomes. The role of Reward Value is to ensure that the collected data is fit for compensation analysis purposes.

2. Reward Value merges the resulting data to several other external data sources, including materiality classifications based on SASB, performance measures (cf. 1. Above), and compensation outcomes. Reward Value will analyze the resulting dataset in order assess to what extent companies focus on ESG, to what extent companies focus on the material topics, to what extent this company focus relates to (changes in) ESG performance, and to what extent this aligns with pay. Additionally, if we develop a panel dataset, Reward Value will try to estimate the extent to which ESG focus is a predictor for future changes in firm ESG performance.

3. Reward Value and Diligent Institute will publish a research paper based on the conducted analyses.

Experiments

Whilst many stakeholders, boards and shareholders will agree that compensation policy can be improved, there is less agreement on what this change should constitute. This may be partially attributed to the fact that evidence on the efficacy of new models for rewarding CEOs is scarce. The resulting paradox is that willingness to change is low, and no new observational data becomes available.

We're finding a way out of this problem by running online, laboratory and within-firm experiments. This allows us to test potential new compensation models so that we can arrive at evidence-based compensation policy that drives the right behavior by CEOs. We take a broad approach to this experimental redesign of remuneration and consider factors beyond the classical principal-agent approach, including leadership style, personality traits, teamwork and culture.

Workplan

Reward Value has developed a workplan for the experiments. A comprehensive overview of this workplan is outlined in our project proposal to the Goldschmeding Foundation. Our approach consists of three parallel workstreams.

1. Online experiments in order to measure how respondents react to new compensation mechanisms based on their intrinsic motivation for generating good societal outcomes as well as personality and leadership traits. The result of this workstream are estimates of the effects of compensation as a function of CEO characteristics.

2. Classroom experiments in order to measure how the dynamic in the boardroom is affected by (changes in) compensation models. The result of this workstream is an estimate of the degree to which changes to compensation policy will change behavior in the boardroom.

3. In-company experiments in order to more accurately assess the real work working of new compensation models. The result of this workstream is a measurement of the real work effectiveness of compensation reform. Additionally, the in-company experiment can function as an example to other companies to experiment as well.

All experiments employ a combination of research methods, including literature reviews, interviews with experts, experimental data collection and quantitative analysis. Reward Value will publish several reports based on the different workstreams.

Principles

Although many organizations and stakeholders recognize that changes to executive pay are sorely needed, coordinating on a joint push toward a new equilibrium is difficult. Many organizations and stakeholders prefer not to be the first and/or only mover. Many organizations and stakeholders don't necessarily agree on the direction and magnitude of the push towards a new equilibrium. In short, there are (temporary) organizational and governance frictions that hinder the development and adoption of a new remuneration model across the board. In an effort to reduce such governance frictions, Reward Value is coordinating the development of a set of Principles for Responsible Remuneration (PRR). These principles are developed jointly with stakeholders. This co-creation allows for the process to be part of the solution of achieving agreement on the direction of change. Upon agreement of the PRR, the PRR may become a touchpoint for meaningful engagement about and governance of executive pay.

Remuneration Disclosure Guidelines

Companies are bound by various requirements for their reporting on remuneration, both through legislation and regulations and through (self) regulation in the form of governance codes. Companies are generally compliant with such requirements, but despite such compliance, concerns remain about the extent to which shareholders and stakeholders can successfully monitor companies' remuneration policies. This is partly the result of the fact that remuneration reporting is often not standardized, companies have a relatively large amount of freedom to define broad standards at their own discretion, and only rarely offer extensive and substantive substantiation for the choices made in the remuneration policy. Concerns about the "quality of transparency" are the result. To help companies design their remuneration reporting in such a way that the expectations of stakeholders and shareholders can be met, we propose to develop a guidelines document for high-quality remuneration reporting. In such a document we not only map out what the best practices are now, but especially how they can be improved. By sketching such an 'ideal type' of remuneration reporting, we hope to encourage market parties to make their own remuneration reporting more transparent, for example by standardization and by offering more substantive explanation of choices in remuneration.