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The value of Intangibles to overcome the systemic crisis

In collaboration with:

BILANCIARSI VALORE SOSTENIBILE

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more than $54 billion (USD) – or 10% – of a deal's value depends on the rate at which critical employees separate during or immediately after corporate transactions. To explore this point further, Hewitt compared the survey responses of companies that exceeded deal objectives (Overachievers) versus those organizations that did not achieve their deal objectives (Underachievers). In its analysis, Hewitt found a clear link between deal success and investment in leadership and key talent issues. "Overachievers" and "Underachievers" both say leadership and talent strategies are important to the success of a deal (69% versus 62%, respectively). However, less than a third of "Underachievers" report their leadership and key talent strategy in transactions as being effective, compared with 70% of "Overachievers". The latter are also twice as likely to effectively identify and retain leaders (81% versus 42 %) and assess critical talent (73% 35%).

In conclusion, Hewitt research and daily practices consistently demonstrate a direct link between leadership, talent management and business performance[85]. A greater focus on operational performance and on relevant and reliable metrics to assess it are always more essential. However, a rigorous and timely execution of HR policies is not enough to guarantee long term sustainable performance. The competitive advantage of an organisation will also depend on its ability to articulate innovative people management policies in anticipation of emerging business paradigms that affect the world of work and change the way business operate.

5.14 Executive compensation and intangible assets

Piero Marchettini[86] Managing Partner of Adelaide Consulting[87]

In the design of an executive compensation policy the choice of the performance measures plays a critical role. As it has been noted "*Measures give relevance to rewards; rewards give meaning to measures*". In fact "*While organizations develop a variety of measures, they tend to fall into the areas of finance, internal business, innovation and learning, and customer satisfaction*"[88]. More specifically, on the basis of the Kaplan and Norton Model of the "*Balanced Scorecard*" the performance measure could be structured taking into account the following criteria (see *Table 1*).[89]

1. *Resource focused* -These are measures that imply the use of the benefits received from the resources of the organization.
2. *Process focused* - These are measures that relate more directly to how things are done in the organization.
3. *External – driven* - These are measures that reflect the market place in which the organization operates.
4. *Internal – driven* - These are the measures that are more likely in the control of the organization.

On the basis of these criteria 4 categories of performance measures have been identified:

1. *Financial Metrics*, subdivided into Value Creation and Stakeholder Return.
2. *Customer Metrics*, subdivided into Time to Market and Customer Satisfaction.
3. *Operational Metrics*, subdivided into Operational Efficiency and Resource Utilization.
4. *Capabilities Metrics*, subdivided into Human Resource Capabilities and Internal Effectiveness.

Unfortunately in many companies several of the specific measures included in these 4 categories have been totally ignored and, in any case, the top management has been traditionally rewarded only on the basis of the Financial Metrics. As a recent survey[90] shows over 90% of the performance measures of stock option and long term incentive plans are based on Financial Metrics (mainly Total Shareholder Return and Earnings per Share). Even in the annual bonus plans about 2/3 of the performance measures are based on Financial Metrics (mainly Annual Profit). (see *Tables 2 and 3*).

What is the reason of the focus on only one of the 4 quadrants of the Kaplan and Norton Model? In our opinion the focus on Financial Metrics is connected with

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[85] Hewitt Top Companies for Leaders Study, 2009.

[86] Piero Marchettini has thirty years experience in the insurance, law and consulting fields and during his career, he has practiced law at the Milan Bar and worked as a Senior Consultant with Towers Perrin in the Paris office before becoming a founding partner of H.R.C. International and Managing Director of Watson Wyatt Italy, H.R.C. Italy.He is a frequent speaker at national and international conferences and author of several articles in leading reviews on benefits and compensation issues.

[87] Adelaide Consulting is a consulting boutique founded in 1996, based in Geneva and Milan, and specialized in Corporate Governance and Executive Compensation.

[88] Tomas B. Wilson, *Innovative Reward System for the Changing Workplace*, New York 2003, II Edition, p.75 and p. 90.

[89] R. Kaplan and D. Norton *The Balanced Scorecard - Translating Strategy into Action*, Boston 1996, mentioned by Tomas B. Wilson, Innovative Reward System for the Changing Workplace, p.91-92.

[90] Report on Eurotop 100 Direct Remuneration, Hewitt 2009, p.19 and 24.

Table 1: Categories of performance measures

	Resource-Focused	Process-Focused
External-Driven	FINANCIAL METRICS	CUSTOMER METRICS
	Value Creation	**Time to Market**
	Revenue growth Revenue (product) mix Profit margins Revenue per employee Economic value added Market capitalization	On-time delivery Cycle time external New product development
	Shareholder Return	**Customer satisfaction**
	Return on equity/assets/capital Cash flow return on investment Earning per share Total shareholder return	Market share Customer feedback Account penetration/n° of services Customer retention Quality of customer treatment
Internal-Driven	OPERATIONAL METRICS	CAPABILITIES METRICS
	Operational Efficiency	**Human Resource Capabilities**
	Budget to actual expenses Product/process quality Reliability/rework Accuracy/error rates Safety rates Cost per unit/transaction	Employee satisfaction Turnover/absenteeism/safety incidents % implementing PM process Succession plan utilization % of employees with requisite competencies
	Resource Utilization	**Internal Effectiveness**
	Process improvements Inventory turns Cost reduction Project/plan implementation	Service/quality index Cost of time per hire Project/plan implementation Response time to resolve issues

Source: Innovative Reward System for the Changing Workplace, Thomas B. Wilson, New York, 2003, II Edition, p.92.

the progressive gap between the growth of economy and the growth of the financial market. As it has been shown by the *Observatoire de la Finance* of Geneva, from 1964 and 1984 the pace of growth of the U.S.A. stock market was very much aligned with the pace of growth of the U.S.A. economy and with the profits of the U.S.A. corporations. Vice versa, from 1984 on the stock market started to grow at a faster pace than the economy and the corporate profits grew at a lower pace. The gap between stock market growth and corporate profits growth remained relatively narrow for about a decade, but from the mid '90s on it became huge.[91] (see *Table 4*).

It is now interesting to observe the relationship between this gap and the evolution of the executive compensation during the past 50 years[92].

20 years of executive pay escalation

For a long period of time (basically from the early 60s to the beginning of the 90s) the scenario concerning executive compensation was reasonably stable and predictable. More specifically:

- chief executive pay was a *"reasonable"* multiple of rank & file employee pay (about 40 times in U.S.A., much lower in Europe and in Japan);
- the average growth of the stock market was in line with the growth of the G.N.P. (about 3% per year in real terms);[93]
- financial industry compensation levels were very much in line with other industries.

This scenario changed dramatically with the deregulation taking place in many previously regulated industries in most Western countries and, particularly, in the financial industry which had a great impact. Starting from the mid 1990s the economy and the executive compensation experienced a season of excesses:

- in the U.S.A, chief executive pay rose from about 40 to over 400 times the pay of a rank-and-file employee (mostly due to stock option plans);[94]
- the average growth of the stock markets became in several countries significantly higher than the growth of the G.N.P. (mostly thanks to the internet & structured financial products bubble);
- financial industry compensation levels bypassed by about 60% levels of other industries, though employment in finance has not significantly grown.[95] [96]

Executive compensation become more and more dependent on share plans (stock options, stock grants,

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[91] Pierre-Alexandre Sallier, *Chercheurs et banquiers denouncent les derives d'une finance toute-puissante*, Le Temps, 24 October 2009.

[92] Piero Marchettini, *Executive Remuneration and the Latest EU Recommendation*, Benefits & Compensation International, November 2009, p.3.

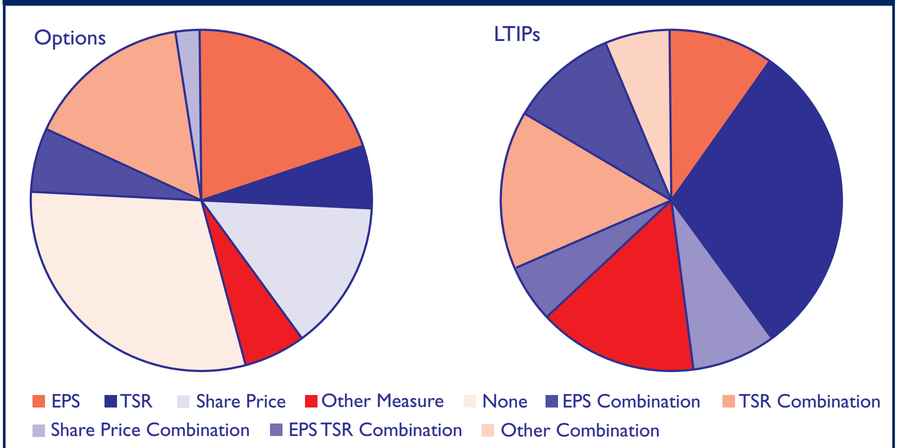
[93] Gary Becker and Kevin Murphy, *Do no let the "cure" destroy capitalism, Financial Times*, 20 March 2009.

[94] N. R. Narayana Mutrthy, *Greed is not good, World Business*, April 2006, p. 15.

[95] Martin Wolf, *Cutting back financial capitalism is America's big test*, Financial Times, 15 April 2009.

[96] Myret Zaki, *Les salaires contestés de la finance*, Le Temps Lundì Finance, 9 February 2009.

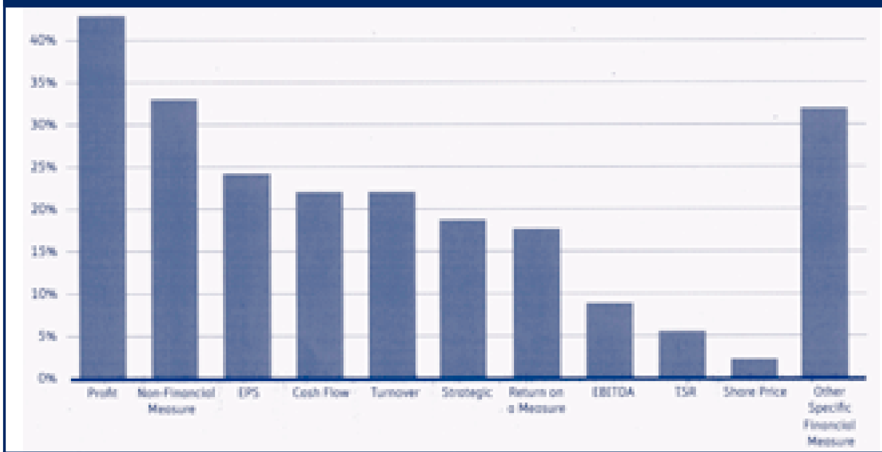
Table 2: Performance measures in options plans and ltips



Source: Source: Hewitt (Report on Eurotop 100 Directors' Remuneration, 2009)

performance shares…), thus contributing to increase the so-called "*long term incentive*" (LTI) component of the executive pay cake. Currently LTIs represent about 2/3 of the total direct compensation of a CEO in U.S.A. and about 1/3 in Europe.[97] (see *Table 5*). Under this scenario it is not surprising that

Table 3: Performance measures in annual bonus plans



Source: Hewitt (Report on Eurotop 100 Directors' Remuneration, 2009)

the overwhelm majority of the performance measures of stock option and long term incentive plans is based on financial metrics such as Total Shareholders Return. Clearly financial measures presented a few significant advantages:

- first of all they are based on numbers and numbers are considered by definition "*objective*";
- second, financial numbers are certified by the big 8 (now big 4) international audit firms and the reliability of their reports is given for granted.

Unfortunately many financial scandals in the recent and less recent past (Enron, Worldcom, Parmalat, Royal Ahold, Vivendi, U.B.S.,...) have shown that numbers are far from giving on objective picture of the enterprise value. Some of these scandals has also shown that audits made by the big international firms have been often too complacent, without understanding that "*the client*" is not the management, but the shareholders and the stakeholders.
Nearly a decade ago Enron brought down Arthur Andersen and now Ernst & Young has been criticized in connection with the Lehman failure to question or challenge off-balance sheet transactions[98].

The European Union and the Financial Stability Board reaction to pay excess

The Golden Age of executive compensation ended abruptly with the 2008 U.S.A. financial crisis, which became

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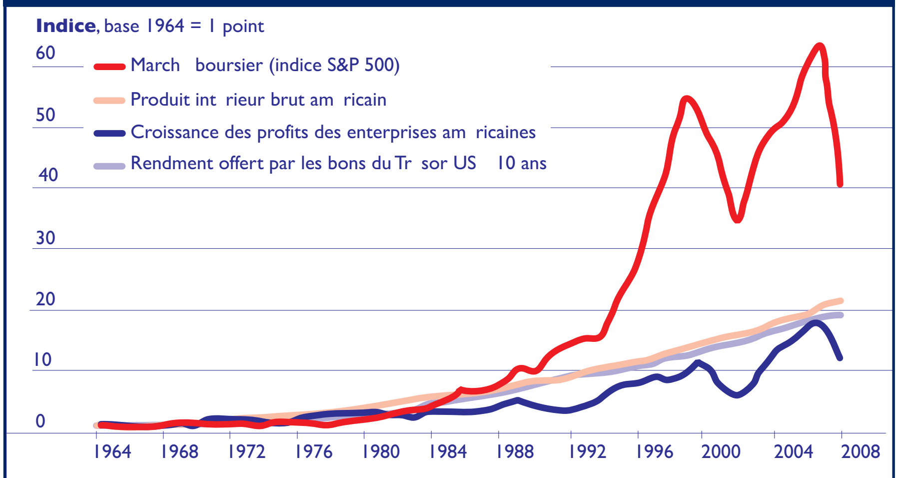
[97] *Report on Euro top 100 Direct Remuneration*, Hewitt 2009, p.8.

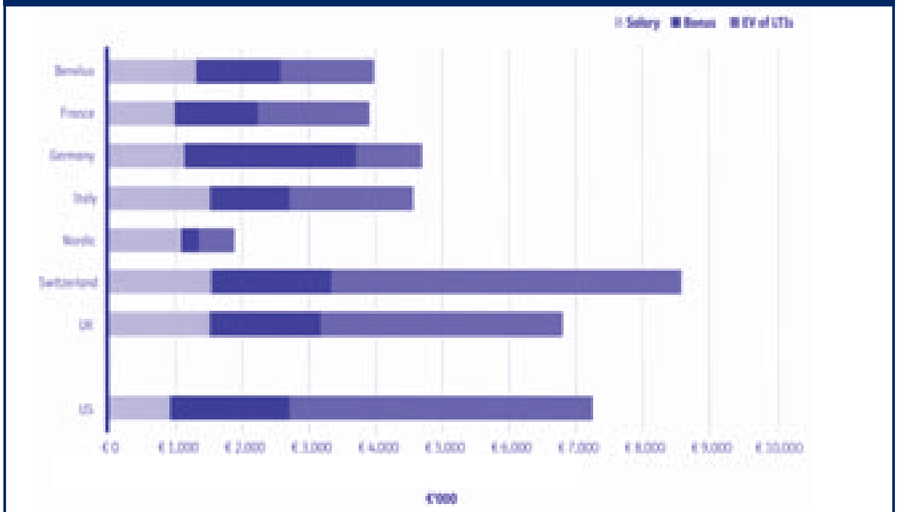
[98] As it has been observed *"The problem is acute in the US, where fear of litigation has led to a culture of box-ticking. E&Y signed off on repo transaction that published billions of dollars' worth of Lehman's assets off-balance sheet not because it believed they served a real commercial purpose, but because accounting rules allowed this. It focused on the form, not the substance, of the deals. It is easy to see how this has evolved. It is far easier for an accountancy firm to retain a lucrative relationship with its clients if it does not sit in judgment on their activities, but simply adheres to a set of blind rules. Auditors can more easily defend lawsuits when things do go wrong if a rule book can be appealed to. But this is precisely why the whole system is so frustrating from the investors' perspective. The more rule-driven auditors are, the less valuable their work is as due diligence." (Accounting failure: Auditors need to remember who their costumers really is,* Financial Times, 16 March 2010).

Table 4: Growth of Economy, stock market and corporate profit - (U.S.A 1964-2008)



Source: Observatore de la finance, Geneva

Table 5: Median target total direct compensation, highest pay executive wihev



Source: Hewitt (Report on Eurotop 100 Directors' Remuneration, 2009)

in 2009 a worldwide economic crisis. As expected, public opinions both in Europe and in U.S.A. made a link between excessive pay (specifically in the financial industry) and the economic crisis. They have also identified several responsible parties: greedy executives, weak remuneration committees, complacent consultants, inadequate regulators and inattentive and inactive shareholders. In fact:

- remuneration committees have failed in controlling the escalation of executive pay (specifically as far as stock plans and golden parachutes were concerned);
- compensation consultants ignored obvious conflicts of interest by working at the same time for the top management and for the remuneration committee;[99]
- non executive board members in the financial industry have been unable to grasp[100] the relationship between company risk and traders/financial specialists incentive schemes;
- institutional investors have poorly performed in assessing the board members skills and the boards effectiveness.

This failure is also due to the fact that shareholder value (represented by quarterly dividends and share price gains) was considered the main strategic goal, not a result of the long- term growth of the company.[101] Consequently, as long as shareholder value was apparently going up, non executive board members have been very reluctant to challenge poor corporate governance practices.

In this scenario both the European Commission and the Financial Stability Board decided to intervene by enacting a Recommendation concerning the remuneration of directors of listed companies (2009/385/CE)[102] and a series of Principles concerning the remuneration

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[99] Gretchen Morgenson, International Herald Tribune, 6 December 2007.

[100] Paul Strebel, *Time to bring real shareholders back on board*, Financial Times, 13 February 2009.

[101] Even Jack Welch, considered as the prophet of *"Shareholder value"* recently said: *"Shareholder value is a result, not a strategy"* (*A need to reconnect*, Francesco Guerrera, Financial Times, 23 March 2009).

[102] Commission Recommendation of 30 April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (2009/385/EC), Official Journal of the European Union, 15 May 2009.

policies in the financial sector.[103] Both the EU Recommendation and the FSB Principles concern *inter alia* the following areas:

- variable pay;
- termination indemnities;
- share programs.

We will focus our attention on the most relevant and innovative features in these areas.

1. ***Variable pay***
   Variable pay should be linked to the long-term performance of the company and must be recognized only when assigned objectives are actually met. These objectives should be established on the basis of both financial and non financial criteria (such as improvement of intangible assets).
   A significant portion of the variable pay (specifically from 40 to 60 % in the financial sector) should be frozen, to be paid only after a certain period such as 3-5 years, when short - term results could be considered as definitely delivered. Variable pay could be reclaimed, if paid on the basis of data manifestly misstated.
2. ***Termination indemnities***
   The era of golden parachutes is definitely over. The guidelines contained in the EU Recommendation and in the FSB Principles establish a maximum termination indemnity corresponding to 2 years of base pay.
   No payment should be made in case of dismissal due to inadequate performance. Also no payment should be recognized in case of voluntary resignation. The only exception is resignation due to a merger / acquisition or to a change in company strategy.
   The widespread practice of "*forgetting*" at termination of employment loans made to top executives must be eliminated.
3. ***Share programs***
   Vesting should not be recognized before at least 3 years and should be subject to specific performance criteria. Once shares become vested, they should be in part retained until the executive reaches the end of his/her mandate.
   No share options should be awarded to non executive directors.

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[103] *Compensation Principles and Standards Assessment Methodology*, Basel Committee on Banking Supervision, Bank for International Settlements, January 2010.

[104] Fabio Pennetta and Paolo Angelini (Eds.), *Financial Sector pro - cyclicality - Lessons from the crisis*, Banca d' Italia, Questioni di Economia e Finanza, N°44 April 2009, from p. 61 on.

A longer term focus in the executive compensation practices

Most of these proposals have been influenced by the short-term focus of many current incentive plans. More specifically in the financial sector the following solutions have been proposed[104]:

- elimination of guaranteed bonuses and golden parachutes (against the risk of "*pay - for - failure*");
- cap on cash bonuses, cancelling of stock options, substituting them with restricted shares redeemable over a 10 – year period (against the so-called "*short – terminism*" approach);
- claw back of payments made to risk takers whose decisions/actions destroyed client assets and shareholder value (against the systematic search of a "*fake alpha*");
- serious analysis of sources of profit by focusing on know-how & innovation versus cheap money & excessive risk. In fact, interest rates are established by central banks, the cost of the risk should be taken into consideration and internal risk management must be reinforced.

Basically the 2008/2009 crisis had a significant impact on the executive compensation practices (and in the financial sector in the compensation practices in general). More specifically:

- a significant portion of the annual bonus (from 40 to 60% in the financial sector) will be deferred during a period of 3 to 5 years;
- in the medium term there will be a trade off between cash and shares (in the financial sector at least 50% of the variable pay should be made under form of shares or investments whose value is linked to the value of the company shares);
- termination indemnities and/or severance payments could be reduced in case of poor performance.

All these changes will have the effect of transferring a significant portion of the total direct compensation of one executive from the short-term (1-3 years) to the medium-long term (3-10 years). This transfer may have a significant impact on the choice of the performance measures adopted to evaluate the top management performance and to determine its reward. In fact:

- shareholders have realized that, despite very favourable financial results certified by leading international auditors, the business and economic disaster of the company was just around the corner;
- top managers cannot take advantage any more of huge short-term rewards linked to financial results, but they have to rely on the long-term success of the company and on the sustainability of its growth.

Under these circumstances the performance measures linked to Non-Financial Metrics become more and more relevant. Only the new products development, the product and process quality, the customer retention and satisfaction, the development of the employee requisite competencies, the employee safety, retention and satisfaction… will be able to guarantee the long-term development and success of the company.[105]
All these factors are based on the so-called Intangible Assets. The concept of Intangible Assets is certainly not new and several companies have developed during the past 15 years, together with the Financial Balance Sheet, also a Balance Sheet of Intangible Assets[106].
Nevertheless, so far, shareholders have hardly grasp the real value of Intangible Assets: they consider them as "*nice to have*", probably much more focused on the various stakeholders (employees, clients, local communities…) expectations, rather than on creation of shareholders value.
The recent financial and economic crisis may have changed their minds (at least the ones of stable institutional shareholders). There is no long-term safety for their investments without a careful management of the Intangible Assets of the companies where they invest. It is now up to them to review the performance measures chosen to monitor and reward the top management of these companies.
In fact some large French companies have already chosen for their top management performance objectives linked to Intangible Assets. This is the case of the leading insurance AXA (where products innovation and market diversification are included among the objectives of the C.E.O. variable pay and performance shares) and of the leading car manufacturer PSA (where the quality of the product represents 55% of the C.E.O. annual bonus).
Furthermore a recent French law (*Decret 31 mars 2009*) excludes any payment of bonuses/incentives to top executives of companies who have made significant layoffs, regardless of their financial performance.
Recently some leading Dutch companies have decided to link part of the bonus of their top managers to sustainability. This is the case of DSM (a life sciences group) and of TNT (a postal operator). Another Dutch company (AKZO Nobel, leading worldwide chemical company) was a pioneer in this area, by linking half of its long-term incentive scheme on its position in the Dow Jones sustainability index for chemical companies[107].
Furthermore two Swiss leading experts (Anne Heritier Lachat, Board Member of Finma, the supervisory authority on financial market, and Rajna Gibson, Director of the Geneva Finance Research Institute) have indicated that the remuneration policies must give the priority to ethic values, because honest managers are unlikely to manipulate financial figures. Moreover, executives in charge of compliance and internal control should be better rewarded.[108]
The shift from Financial to Non-Financial Metrics (mainly Intangible Assets) is also coherent with the increased focus on stakeholders interests, instead of shareholders value.
A company which pursues a long-term sustainable growth will be able to protect its stakeholders interests much better than a company focused on short-term shareholders value.
Furthermore the protection of stakeholders interests should be able to guarantee in the long-term the shareholders value as well.

5.15 An Expanded Intellectual Capital Framework

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Vincent Leung - Co-Founder of Predictiv Asia[110]

1. Intellectual Capital Framework

On the average, market values of corporations exceed their book

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[105] The relationship between the good practices in the human resources area and the company performance has been analysed by Andrea Gasperini and Nadia Raso, *Capitale umano e performance di business*, Milano 2008, p.51.

[106] Franco D'Egidio, *Il Bilancio dell'Intangibile*, Milano 2001.

[107] Richard Milne, *Drive to link pay to sustainability begins*, Financial Times, 24 February 2010.

[108] Yves Genier, *Tentative de reglementation des bonus: le risque d'une impasse*, Le Temps Lundi Finance, 22 March 2010.

[109] CCLFI is a non-profit organization based in the Philippines is specializes in organizational learning and change, knowledge management (KM) and knowledge-based development. Provide courses, trainings and workshops to groups of individuals including students and KM enthusiasts, and select organizations such as corporations, government agencies, non-profit organizations, funding and development organizations that are looking for ways to generate greater value for its customers and stakeholders. CCLFI is composed of a network of individuals, experts in their own fields, who practice and advocate knowledge management.

[110] Predictiv Asia - Specialized in the strategy formulation and assessment of intangibles such as brand, reputation, customare satisfaction, innovation, management credibility and strategy execution, for corporations from MNC to SME and from NGO to Governmental Bodies. Based in the United States, the firm has a pool of intellectual capital professionals with years of practical experience and successful cases.