Operationalizing Sustainable Economic Value and other Governance Principles

Expectations for U.S. listed company implementation by January 1, 2018 have been outlined by the Investment Stewardship Group. https://www.isgframework.org/ Some of the signatories to-date include Blackrock, Vanguard, State Street, Wellington, T. Rowe Price, J.P. Morgan, Walden, CalSTRS, OPERS, Florida SBA - and activists like Trian and ValueAct, among others.

Setting strategy, goals and management incentives:

The investors are asking that boards explain ***how the drivers of incentives clearly link to long-term strategy and "sustainable economic value creation"*** * (not stock price). The investors note that boards need to re-evaluate/change incentive structures when long term strategy (and by implication, also when sustainable economic value creation) changes.

What board members are saying:

In discussions with public company board members and board chairs, here are some of the views we've heard:

- *"This is just a matter of good business management."*
- *"This makes sense. It lets you know how relevant the business is to your major stakeholders. We do this in the mutual company I'm on the board of. We think about how our actions are impacting our customers, our employees, the community. Why not use those same principles of long-term thinking at public companies?"*
- *"The focus on long-term thinking is welcome. Now if we could just get the [sell-side] analysts to do the same."*
- *"I've been saying for a long time that the emphasis on stock price was wrong."*
- *"This is a great way to create better alignment, internally -- and with stakeholders. To do it effectively, however, does require rigor in the process."*
- *"Processes like these are extremely powerful in motivating extraordinary results."*
- *"This is timely. We are having a strategy session coming up soon."*

How to operationalize this, as a practical matter:

To be able to explain how the drivers of incentives *clearly link* to long-term strategy and "sustainable value creation," companies need a solid process that includes the following steps:

- Step 1: Long term strategy is determined by evaluating strategic alternatives based on their contribution to "sustainable economic value." *
- Step 2: Strategy is directly linked to annual/rolling budgets (if you do those) and those budgets are quantified in terms of sustainable economic value (not just earnings).
- Step 3: The measures of sustainable economic value and/or the key drivers of sustainable economic value (in the form of short and long-term goals selected because of their contribution to sustainable economic value as reflected in the long-term strategy and annual/rolling plans/budgets) are then used as the drivers in incentive plans.

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What is the board's role?*:*

- Oversee management measurement of sustainable economic value to ensure robust, accurate calculations and that they are imbedded in the board's and the organization's decision-making processes (including capital allocation, M&A, strategy, budgets, goal setting, rewards and incentives).
- Implement board practices that incorporate sustainable economic value in strategic reviews, risk reviews, financial and non-financial performance reviews, succession planning and incentive design.
- Ensure appropriate disclosures related to how the audit and compensation committees of the board oversee the calculations and how the board uses them in strategy formulation as well as capital allocation, M&A, budget and vendor approvals, goal setting, CEO performance reviews, and in rewards and incentives throughout the company.

Consider*, as a key element in succession planning, choosing a senior leader to carry the torch.*

Other issues the shareholders address include:

- Board composition, performance, and elections: looking for independence, diversity, and attendance/time, and periodic refreshment – with independent chair or lead director; expect elections: annually, majority of the votes cast, proxy access; will judge board performance based on the company's overall long-term performance, financial and otherwise and will vote no if directors are unresponsive to shareholders
- Shareholder and management proposals: implement shareholder proposals if there is significant shareholder support - or explain; understand/respond if there is significant shareholder disagreement with management proposals
- Dialogue and information: make independent directors available to meet with shareholders as part of a regular practice of directors in seeking out information from diverse sources
- Shareholder voting rights: expect shareholder rights to be in proportion to economic interest
- Explain corporate governance and board practices: including board refreshment practices (evaluations, term limits, retirement ages), extraordinary pay decisions for NEOs and if have anti-takeover measures, explain why in long-term interest

*Sustainable economic value is an approach to valuing a company based on understanding the value the organization will create not only for shareholders, but all stakeholders. For example, sustainable economic value considers not just the value created for the company by customers, but the value the company creates *for* customers. For employees, sustainable economic value recognizes the full value employees create for the company as well the value the company creates for them-- and in a similar way, sustainable economic value considers the full value to/from suppliers, government, capital providers, the community and society – thus it includes all aspects of ESG. What sustainable economic value is not: simple EVA or ROI or earnings or the balanced scorecard. Sustainable economic value reflects differential risks. For more information, see the book Economic Value Management: Applications and Techniques, an approach to managing based on stewardship, in the Wiley Finance Series.

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