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MEASURING FINANCIAL PERFORMANCE

WEBINAR AND GROUP DISCUSSION

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MEASURING FINANCIAL PERFORMANCE

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Few would argue with the suggestion that executive reward should be linked to the performance of the business. With the hit to revenues and the increased scrutiny of corporate behaviour resulting from the Covid pandemic, the need to be clear about what we mean by company performance and why we are rewarding executives for it has never been greater. There are, however, a number of ways of measuring a company's performance and still more ways of linking that performance to reward. Remuneration Committees find themselves faced with three questions:

1. How do we define and measure corporate (and management) performance – recognising the perspectives of different stakeholders?
2. How do we link superior management performance to an appropriate level of reward?
3. What is the role played by critical non-financial performance measures – including ESG measures – and how do we ensure they have sufficient 'rigour'?

PARC has therefore organised a trilogy of events focusing in turn on each of these questions. The event on 14 July tackled the first question. The second will be covered in November 2021 and the third in Spring 2022.

WATCH A FULL RECORDING OF THE EVENT HERE

To help us develop our understanding of what is meant by superior financial performance, Alex Edmans, explained the various ways we might define a company's performance and the effects these definitions have. There is no right or wrong metric. It all depends on what you are aiming to do.

A) NET INCOME

Alex began by explaining how Net Income, the basis of most financial performance measures, is calculated. He talked through the rationale behind depreciation and amortisation and explained why companies use EBIT (Earnings Before Interest and Tax) and EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortisation) to highlight specific factors that impact on company performance.

B) EARNINGS PER SHARE

Net Income (aka Profit After Tax) then forms the basis for calculating Earnings Per Share (EPS) – i.e., by dividing Net Income by the number of outstanding shares *(the company's stock currently held by all its shareholders)*. This tells us how much the value of the business has risen over the year. It is useful for comparisons over time but not comparable across firms – just like stock prices themselves are not comparable.

EPS can be increased by share buybacks, which simply reduces the denominator (i.e., the number of shares issued). Alex gave an example of how a share buyback had been used by a particular company to achieve the EPS threshold required for the CEO to receive his performance payment.

C) OTHER PERFORMANCE MEASURES

There are situations where companies might not use Net Income to evaluate their performance. For example, the main goal of companies such as Uber, Deliveroo and Facebook – at a certain stage of their development – might be to attract a large number of customers. In situations like this, provided the investors are happy to forgo income now on the assumption of a future payback, it makes more sense to focus on other metrics, such as sales or customer growth. The choice of a specific performance measure will reflect the company's strategic priorities.

D) STOCK PRICE

There is a logic to linking reward to the stock price as this, at least in theory, ties in executive remuneration to the beneficial interests of the shareholders. The most-used performance measure based on a company's share price is Total Shareholder Return (TSR). This is calculated by taking, over a given time period, the change in the price per share plus any dividends paid by the company over the same period and dividing that by the price of the shares at the start of the period. This gives a measure of the percentage gain (or loss) for investors over that period of time. It is less easily inflated through share buy-backs but it can be influenced by short-term factors such as market sentiment or the economic environment.

TSR is often best calculated over longer periods to reflect the fact that some investments and management initiatives can take some time to show up in the share price. Alex referred to some extensive and **detailed research he published in 2011**, to demonstrate that increased employee satisfaction does have a positive impact on TSR but it takes 4 to 5 years to do so[1].

E) EXTERNAL FACTORS

It is difficult (and sometimes inappropriate) to filter out all external factors from measures of business performance. However, as we have been reminded over the past year, sometimes a company's fortunes can be affected by something totally beyond the control of the management. Most obviously, the Covid pandemic produced some clear winners and losers but markets are often affected by less dramatic factors. Alex gave the example of house-builder Persimmon, where low interest rates and a government help-to-buy scheme boosted the company's performance and left its CEO eligible for a £110m pay-out. The CEO received uproar from shareholders, politicians and the media but the case highlights the need for the RemCo to apply its overriding business judgment *(aka discretion)* in the case of performance measures that may be significantly influenced by factors outside management control. One solution might be to compare a company's performance to that of its peers in a similar industry. Therefore, if all companies in a sector benefit from the same windfall, it should be possible to assess how much better one CEO has done when compared to others. However, as Alex remarked, this can be quite difficult to do in practice as some companies, even those ostensibly in the same sector, are different enough from each other that such comparisons can be specious.

F) HUMAN CAPITAL

Investment in human capital, for example in learning and development activities, cannot be treated as an investment and amortised over time. For the purposes of Net Income, it is treated as an expense.

G) SHORT-TERMISM AND UNDERINVESTMENT

Share buybacks have been criticised as a symptom of short-termism and under investment. The argument being that share buybacks artificially inflate Earnings Per Share while diverting cash away from what might otherwise be longer term investment. Alex questioned this, **pointing to some research** he did with a team from PwC which found that, over 10 years, there was very little evidence among FSE 350 companies that buybacks had been used to inflate executive pay[2]. Furthermore, the authors found no relationship between share buybacks and lack of investment, and no evidence that executives were diverting funds from investment projects to fund repurchases. Alex believes that the causes of short-termism lie in the specific measures and targets set to determine pay. He is an advocate of giving executives long-term restricted shares as an alternative to setting complex (and often unrealistic) targets under long term performance plans.

Q & A

Q **In what circumstances is it legitimate to adjust headline financial measures when assessing management performance?**

Why might you filter out industry conditions and what other circumstances might be deemed to be "beyond management control"?

A The "obvious" answer is that you should almost always benchmark for peer performance, to remove industry- and market-wide factors outside the CEO's control – such as the Persimmon CEO being well-paid because house sales volumes were high due to low interest rates and help-to-buy, or oil company CEOs doing well due to a high oil price. It also works on the downside – an oil company CEO shouldn't be punished for a low oil price. Indeed, Nobel prizewinner Bengt Holmstrom's most famous paper shows that you should always filter out industry conditions (except in the rare cases in which a company can affect industry performance – e.g. a monopoly or oligopoly where the firm effectively is the industry). If it's too difficult to define a peer group, you should at least filter out market conditions.

However, the recent study on **CEO Compensation** with Tom Gosling[3] suggests that it's not actually that simple. (The Practitioner Report can be found **here**.) It seems legitimate to filter out the effect of the pandemic since this is outside the CEO's control – but this is seen as unfair since investors and stakeholders are suffering in the pandemic. Thus, the CEO should suffer too. But fairness means that the CEO should also be rewarded for the upside, even outside the

CEO's control – as investors also benefit from upside "luck". As one director said in our survey: "If you operate in a high beta business, then shareholder alignment requires you to reduce pay in cyclical downswings to protect returns and capital. Fairness requires a mirror image on the upside."

Thus, there are two separate issues.

a) Assessing managerial performance (which is what was strictly referred to in the question) should be based on industry-adjusted performance.

b) Pay – it's not clear that this should be adjusted.

Most people think that pay should reflect managerial performance, so (a) and (b) should be the same, but fairness argues that pay should reflect the investor and stakeholder experience. Employees get furloughed in a downturn, even if their performance has been fine; similarly, even if CEO performance has been fine (since industry-adjusted performance is fine), their pay should still fall (i.e., be based on non-adjusted performance) due to fairness.

Q **What do you see as being the most necessary changes to Corporate Financial Reporting – and how quickly do you think they will happen?**

A I am not sure that corporate financial reporting can be changed due to the "objectivity" principle of accounting. You can't capitalise things such as employee training as it's hard to know whether this is an investment, or an expense (something you need to offer to attract the employee, similar to salary).

However, non-financial reporting should be changed. In particular, companies should report much more about their intangible capital, e.g., human capital, innovation, relationships with regulators, customer trust etc. Many people argue that we need metrics. Metrics are certainly useful, but we should be aware of their limitations. Narrative reporting is also important.

See Chapter 8 of ***Grow the Pie*** (Alex's most recent book, published in 2020) for recommendations on corporate reporting[4].

See ***The Dangers of Sustainability Metrics*** for the limitations of non-financial metrics, which people are seeing as a panacea[5].

Q **What do you see as the most significant differences of opinion between 'Investors' and 'Directors' in the area of performance measurement?**

Where do their respective views carry the most weight?

A Investors focus more on long-term shareholder return because it mirrors what they themselves receive. Then, the CEO becomes a co-owner of the firm, who's "there for the journey" alongside investors. Some investors viewed CEOs with targets and bonuses as being treated as employees rather than co-owners. Table 13 of the **CEO Compensation Paper** (p28) shows how investors are strongly supportive of long-term equity, but directors less so.

Investors are also more sceptical of other measures such as ROE, EPS etc. since it's harder to know whether they've been calibrated correctly, particularly for investors who are more removed from a company. Directors are closer to the company and think they can calibrate them reasonably, but investors may view boards as weak and in the CEO's pocket (see Table 6 on p14 of the **CEO Compensation Paper**).

Q **Is it "too difficult" for most FTSE 100 companies to define an appropriate (performance) peer group?**

Ideally, how many companies constitute a peer group?

A Yes, this is something which surprisingly came up in the survey. P29 of the **CEO Compensation Paper** suggests that some directors and investors think it's too difficult to define a peer group because there might not be enough firms within the sector, or they may be quite different even in the same sector. Or, it may be (for performance measures other than TSR) that you can only observe peer performance with a lag – when it's reported in the financial statements, which come out several months after year end, so it's too late.

1. Edmans, A. (2011). *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices.* **http://faculty.london.edu/aedmans/Rowe.pdf**

2. Edmans, A. (2019). *A New Major Study on Share Buybacks.* **https://www.london.edu/news/share-buybacks-1680**

3. Edmans, A., Gosling, T, and Jenter, D. (2021). *CEO Compensation: Evidence From the Field.* **https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3877391**

4. Edmans. A. (2020). *GROW THE PIE: How Great Companies Deliver Both Purpose and Profit.* **https://www.growthepie.net**

5. Edmans, A. (2021). *The Dangers of Sustainability Metrics.* **https://voxeu.org/article/dangers-sustainability-metrics**

Summary and Conclusions

Alex's session explained the most common ways of "Measuring Financial Performance". He defined the various performance metrics, the reasons why a company might use them, and the potential disadvantages arising from each one. As he emphasised, there is no single performance measure that clearly dominates all others. All have their advantages and disadvantages. It is important to understand not only their intrinsic strengths and weaknesses but also the circumstances in which some are more relevant than others.

Alex's research on the differences of opinion between investors and directors on the components of financial performance reveal the perhaps unsurprising finding that shareholders want performance measures to be linked to shareholder returns while directors are less keen. This is a manifestation of the 'agency problem' that has been a subject of corporate governance debates ever since companies were first formed- How do you align the interests of those running the company with those who provide its investment? The answer to this question appears to be as elusive as ever. Alex's recommendation to remove executives' target-based remuneration and replace it with long-term restricted shares might have a certain logic to it, but may meet resistance.

It is likely that any form of evaluation of business performance will involve a range of metrics and an assessment of the impact of external criteria to reach a conclusion on how well the company has performed and what part its managers played in achieving that performance.

Most large businesses operate in a number of complex environments and in this context, business judgement is as important as financial data when making the final decision on the level and quality of performance achieved. And, as we will discuss in Part 2 of this Trilogy, this applies even more to determining an appropriate level of reward. As one of our members commented during the discussion, it can be as much an art as a science.

The debate over the application of financial performance measures will continue and we will pick this up in our session in November, with Alex's colleague Tom Gosling.

SPEAKER

ALEX EDMANS Professor of Finance at London Business School and Academic Director of the Centre for Corporate Governance, who focuses on corporate governance, responsible business, and behavioural finance. He is also an elected member of the Governing Body. Alex graduated from Oxford University and then worked for Morgan Stanley in investment banking (London) and fixed income sales and trading (New York). After a PhD in Finance from MIT Sloan as a Fulbright Scholar, he joined Wharton in 2007 and was tenured in 2013 shortly before moving to LBS.

UPCOMING PARC EVENTS

House of Lords Lunch Member Lunch	8 September 12.00 – 15.00 LONDON
Building a Future-Fit Workforce Live Panel Discussion and Report	22 September 16.30 – 19.30 LONDON
Building and Sustaining Great Organisations Conference Live	12 October 9.00 – 20.00 LONDON
Financial Performance Measures – their use in Incentive Plans Webinar and Online Discussion	4 November 17.00 – 18.30 ONLINE

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