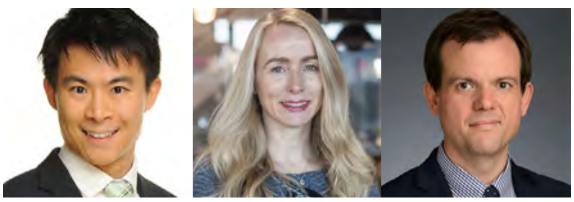
PART 3: PARC'S PERFORMANCE TRILOGY

LIVE-STREAMED MEETING

ESG and Non-financial Performance Measures

THURSDAY **26** MAY | LONDON



Prof. Alex Edmans, London Business School
Maureen O'Shea, Baringa
Matthew Roberts, Fidelity International

ESG and Non-financial Performance Measures

Alex Edmans Professor of Finance, **London Business School**

Maureen O'Shea Management Consultant Partner in Supply Chain and Sustainability, **Baringa**

Matthew Roberts Stewardship Analyst, **Fidelity International**

Background and Context

This meeting was the third in our 'Trilogy' on Performance Measures, which examined the broad area of corporate performance and how it should be defined, measured and rewarded.

1. In the first session *(14.07.21)*, Alex Edmans covered how organisational performance might be defined from the perspective of investors and other key external stakeholders, and the effects these definitions have on the measures companies choose to use.
2. In the second session *(04.11.21)*, we looked at how we assess the management contribution to financial performance and how we link that contribution to reward. Our panel, George Feiger, Tom Gosling, and Alan Giles, focused on the use (and abuse) of Financial Performance Measures in Incentive Plans – both annual and longer term.
3. In this third session *(26.05.22)*, we addressed the role of non-financial performance measures and the extent to which Environmental Social and Governance (ESG) criteria should be used to create focus on and reward a company's social impact and environmental sustainability.

As our event chair Maureen O'Shea said in her opening comments, ESG has *"roared up the agenda"* in the past 2-3 years. The Business Roundtable in the US and the Institute of Directors in the UK, hitherto advocates of free-market economics and shareholder primacy, published high profile statements about corporate purpose and the critical need to serve multiple stakeholders. The World Economic Forum's Davos Manifesto in January 2020, stated that *"The purpose of a company is to engage all its stakeholders in shared and sustained value creation."* In the same week, Larry Fink, CEO of BlackRock, wrote his now famous letter stressing *"the importance of serving stakeholders and embracing purpose."*

The Covid pandemic increased the public scrutiny of companies, especially those that had taken government financial aid. The 'all in this together' and build back better' political rhetoric increased pressure on companies to behave in a socially responsible way. In parallel, severe climate events and global protest movements, such as Black Lives Matter and MeToo, increased the intensity of the broad ESG debate. And during the horror of Russia's invasion of Ukraine, companies came under public pressure to pull out of Russia in much the same way that they have been admonished to disinvest in harmful or unethical practices.

Commentators are divided on the extent to which the invasion has either thrown a curveball at the broad ESG movement, or has been a coming-of-age moment for the ideals that underpin it. So, either:

a. the notion that investment dollars focused on environmental, social and corporate governance could help to change the world for the better has been revealed as hopelessly exposed to shifting priorities during a fast-moving geopolitical crisis;

or:

b. the idea has triumphed, that companies should pay heed to concerns around the planet, people and governance, as well as to the priorities of their shareholders – and, at very least, it has turned out to be more deeply rooted in corporate life than was previously imagined.

The economic headwinds of the 2020s – increasing environmental pressures, political instability, demographic change and the global push for Carbon Net Zero – will continue to shape the debate. Our understanding of companies' Environmental Social and Governance 'duties' will evolve as events take their course.

It was against this background, then, that our three speakers were presented with the challenge of bringing greater insight to this rapidly shifting scene and of helping us to develop clarity on how we build ESG objectives into our measurement of organisational performance.

Three different but linked perspectives on ESG were put forward by our speakers:

- **Matthew Roberts** – the Institutional Investor perspective
- **Maureen O'Shea** – the Business perspective
- **Alex Edmans** – the Performance and Reward perspective.

However, a number of common themes emerged:

WATCH EACH SPEAKER SESSION HERE:

1 ESG has significantly risen up the business agenda

Maureen O'Shea noted the increased focus on ESG in the context of the Covid pandemic and shifting attitudes to business and work. The past two years have given a clear view of the interconnectedness of the world and caused a lot of people to re-assess their view of work. The Great Resignation, which has seen people quit certain sectors such as hospitality, and the Great Retirement, which has seen people over 50 leave the workforce altogether, are symptoms of growing dissatisfaction and increasing expectations on the part of employees. Whilst COP26 has seen a sharp increase in focus on sustainability and environmental protection.

As Matthew Roberts said, investors are taking the concept of shareholder stewardship seriously and are increasingly seeing it as their role to influence positive behaviour within companies.

2 The risks from failing to engage with ESG are increasing

Maureen noted that this was both a **regulatory** and a **reputational** risk. While it has been the case for many years that companies falling short of ethical standards can be punished by regulators, they can now also be punished by public and media reaction. A company is only one Twitter storm away from a damaging front-page headline.

It's no longer enough simply to avoid a such reputational damage. To attract younger workers (and especially graduates) in a tight labour market, employers must have evidence of their commitment to ESG criteria and especially to Carbon Net Zero. Potential recruits from this age group are very alert to 'greenwashing' – statements by companies on their environmental credentials which have little to back them up. They are only a Google search away from exposing any lack of sincerity. There are now websites dedicated to helping identify how much substance there is behind companies' ESG statements.

Ultimately, it will be the companies that meet these rising expectations from consumers, investors and employees that gain the competitive advantage. As Maureen put it, *"sustainability has gone from a nice-to-have to a core business objective."*

3 ESG analysis is imprecise

Matthew Roberts pointed out that markets are only semi-efficient and don't always value long-term thinking. Assessment of sustainability therefore requires a higher degree of expert analysis of the individual company. ESG has added extra dimensions to the assessment of a company's long-term performance. Fidelity employs teams of locally based analysts that can fully assess the entire value chain and thereby understand a company's capacity to deliver on its ESG commitments. Much of this depends on the quality of the board and the extent to which they have the capacity and willingness to hold the management to account.

Low correlations between ESG rating providers demonstrate the imprecise nature of ESG analysis. Rating providers have different views of materiality and weight diffuse E, S & G indicators in different ways. Without knowing the detailed criteria being used, the term is something of a black box. A MIT study in 2020 dubbed this Aggregate Confusion[1].

As Alex Edmans said, ESG is multifaceted and multiple measures of performance give you great flexibility to manipulate the results.

4 Materiality is crucial

All three speakers stressed the importance of materiality in determining which ESG criteria to measure.

Materiality is the test of whether such ESG criteria are material to the company's business model and strategy. There is little point in 'ticking boxes' that have little relevance to the business or over which the company can have very little influence. ESG has encouraged some companies to invest in activities that might look good but which are not material to the enterprise.

As Alex Edmans pointed out, there is research of over 2,000 companies showing that those scoring highly on multiple ESG stakeholder dimensions barely outperformed other companies over a ten year period. However, those companies that scored highly on factors that were material to their business performed significantly better than the market[2].

So, while support for worthy causes that gain media attention might be good in itself, it is unreasonable to expect them to deliver a financial return to the company, or constitute a basis for enhanced reward.

Matthew Roberts also reinforced the point that investing in sustainability requires a clear analysis of those factors that are material to the business and that lead to long term value creation for that particular business. Those factors are not always correctly priced by markets.

5 Implementation is challenging

The ESG agenda is still fairly new. Companies are still thinking through how their ESG goals fit into all aspects of their business models, and this applies especially to supply chains. As Maureen O'Shea explained, many companies are unaware of practices in their supply chains beyond their immediate suppliers. They may have checked that their suppliers are not damaging the environment or employing forced labour but what about their suppliers' suppliers?

Furthermore, as Alex Edmans pointed out, some of the measures employed may also have unintended consequences and incentivise people to do the wrong thing. In a rush to be seen to be doing something, inappropriate 'off the shelf' measures are used. Companies may therefore 'hit the target but miss the point'.

6 Linking ESG Performance to Reward

This makes it all the more difficult to set objectives with enough granular detail to form components of incentive plans.

All three of our speakers argued in favour of encouraging long term share ownership and for the retention of shares after top executives leave the company. As Matthew Roberts argued, this aligns management with the equity owners. Fidelity has long advocated extending the duration of LTIPs for senior executives to a minimum of five years.

Alex Edmans argued that companies should remove the term 'ESG' and simply talk about 'non-financial measures'. Many of these, he said, are inappropriate for linking to remuneration. As an ESG advocate, far from applauding the trend towards incorporating ESG metrics into pay, Alex is firmly against it. Because ESG performance is multifaceted, either the measures will emphasise only certain aspects and miss the others, or else it will try to incorporate them all and become so complex that the company lacks the capacity to operate the incentive arrangements and they lose their motivational effect[3].

Instead, he argues, executives should be paid like owners, with shares linked to longer-term retention, including post-employment for top executives. This would hold executives accountable for the impact of material ESG issues on sustainable performance. According to Alex's research, those companies that focus on material ESG issues will be rewarded for any outperformance via the company's stock returns[4].

---

1. Berg, F., Koelbel, JF. and Rigobon, R. (2020). *Aggregate Confusion: The Divergence of ESG Ratings.* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533

2. Edmans, A. (2021). *No Stakeholder Left Behind: The Dangers of ESG Metrics.* https://medium.com/@alex.edmans/no-stakeholder-left-behind-the-dangers-of-esg-metrics-5369ff66bdda

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

4. Mozaffar, K., Serafeim, G. and Yoon, A. (2016). *Corporate Sustainability: First Evidence on Materiality.* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2575912

Discussion and Conclusions

Despite any imprecision of some of the measures, and the difficulty of their implementation, the broader concept and rationale for ESG is here to stay. As *The Financial Times* remarked at the end of 2020: *"Today's corporate zeitgeist looks notably different versus two years ago, never mind a decade back."*

Political and social pressure on companies from an increasingly well-informed and vociferous population of regulators, customers, and employees is unlikely to abate. As environmental concerns multiply over the coming decade, the expectations placed on companies to 'do the right thing' will rise. This pressure is being felt equally by investors who are, in turn, using their leverage to influence the ESG agenda in the companies in which they invest.

However, as we have seen, defining the ESG criteria that are material for the particular business, embedding those criteria into business processes, and then deciding the relevant translation into reward measures continues to be a major challenge. In the rush to be seen to be doing something, companies are at risk of implementing targets that are not core to their business model and strategy – and which may even be counterproductive. Ratings agencies appear to be as confused as everyone else and can find themselves with wildly different or even contradictory ESG ratings.

Here the vital concept of materiality bears repeating. Careful consideration of what ESG factors and which stakeholders are material to longer term business performance and sustainability is of prime importance. A shotgun approach is unlikely to be successful. As Alex Edmans put it: *"Indiscriminately investing in stakeholders doesn't deliver long-run value to investors, but targeted investment in material stakeholders does."*

All of which makes the definition of organisational performance even more of a diverse and complex exercise. Alex Edmans' suggestion that we simply leave it to the improvement in a company's stock returns to provide the incentive and reward for investment in ESG activities has a certain logic to it and some robust evidence to back it up. Nevertheless, persuading company boards to trust that such an approach will create the essential short to medium term focus on the part of management looks like a tall order.

It may sound like an academic cop out to say that more research is needed. However, it reflects the inevitable conclusion that the debate on how to embed longer term ESG objectives into a broader based approach to the measurement and reward of organisational performance is going to run for a while yet, and as such will certainly feature in future PARC sessions.

SPEAKERS

VIDEO SUMMARY

ALEX EDMANS is Professor of Finance at London Business School. Alex has a PhD from MIT as a Fulbright Scholar, and was previously a tenured professor at Wharton and an investment banker at Morgan Stanley. Alex has spoken at the World Economic Forum in Davos and given the TED talk *What to Trust in a Post-Truth World* and the TEDx talk *The Social Responsibility of Business.* Alex's book, *Grow the Pie: How Great Companies Deliver Both Purpose and Profit,* was a *Financial Times* Book of the Year for 2020.

VIDEO SUMMARY

MAUREEN O'SHEA is a Management Consultant Partner in Supply Chain and Sustainability at Baringa, with 20 years industrial experience in Supply Chain, at local, regional, and global level. Across this time it became increasingly clear that the role supply chain needed to play in the sustainability transition was critical, hence she used four years in consultancy to build out the Sustainable Supply Chain Team for a Big 4 Consultancy and has come to Baringa for their deeper climate change mastery.

VIDEO SUMMARY

MATTHEW ROBERTS is a Stewardship Analyst at Fidelity International specialising in corporate governance and proxy voting matters. Prior to this, he was VP and Senior Corporate Governance Analyst at the proxy advisor Institutional Shareholder Services, Inc., where he was responsible for coverage of the Swiss, German, and Austrian markets. He was also co-chairman of the ISS European Voting Policy subcommittee, responsible for development of the Continental European and UK/Ireland benchmark voting policies (2012-2018).

Financial Performance Measures – Their use in Incentive Plans

Tom Gosling Executive Fellow, **London Business School**

George Feiger Executive Dean, **Aston Business School**

Alan Giles Portfolio NED, RemCo Chair and Chair, **Remuneration Consultants Group**

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 via annual and long-term incentive plans?
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. Alex Edmans tackled Part 1 in our 14 July event and the third will be covered on 26 May 2022. This session focuses on the second question – how do we assess the management contribution to financial performance and how do we link that contribution to reward?

To address this question, we had an initial framework presentation from Tom Gosling, followed by comments and observations from Alan Giles and George Feiger.

Setting the Scene

VIDEO SUMMARY

GEORGE FEIGER has been Executive Dean of Aston Business School since 2013. Previously he founded a wealth management firm; was Director of McKinsey in the US & UK; Global Head of Investment Banking for Warburg; Global Head of Onshore Private Banking for Swiss Bank and UBS; and involved in various venture capital activities. He was Lecturer of Economics at Harvard; and Associate Professor of Finance at the Stanford Graduate School of Business. He has a PhD in Economics from Harvard.

The event chair, George Feiger, set the scene, remarking that, in the discussion of executive pay, there is an **inner perspective**, the debate between investors, who market themselves as custodians of people's wealth, and the company's executives; and an **outer perspective** in which pay is conditioned by external factors such as social acceptability. In some circumstances, the Covid outbreak being one such example, it becomes unacceptable for a CEO to receive a high pay award, even if it was based on what had previously been agreed. Therefore, incentive plans are often constrained by unwritten limits on what companies can do.

George noted that the rise in the ratio of CEO earnings relative the rest of the workforce has not been accompanied by a corresponding increase in productivity in the UK economy. At what point, he asked, does CEO pay cross the line of stakeholder acceptability?

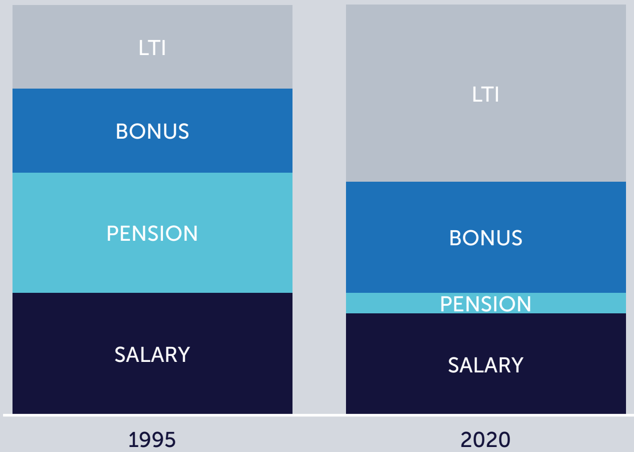
Reward professionals therefore need two key skills, the technical ability to **understand and operate the metrics** they are using and a **nose for the context** – a sensitivity to the invisible red lines. They need to be advisers as well as managers, able to understand the broad context as well as running the technical process.

Incentive Plans

VIDEO SUMMARY

TOM GOSLING is an Executive Fellow in the Department of Finance at LBS where he contributes to the evidence-based practice of responsible business by connecting academic research, public policy, and corporate action. He has 20+ years experience as a board advisor, most recently at PwC where he established and led the firm's executive pay practice. Tom is a regular commentator in print, broadcast, and social media and he has a PhD in Applied Mathematics and is a Qualified Actuary.

Increase in Incentives as a Proportion of Senior Executive Reward



Source: London EDU

Tom took up this theme with a presentation outlining the difficulties in balancing ideas of fairness between investors, senior executives and the wider social context, noting that many of the technical solutions which were supposed to have solved these dilemmas ended up being over-engineered to the point where they simply made the reward process less transparent on all sides. As the stakes have risen, RemCo judgement and discretion have become that much more important.

Theory Behind Incentive Pay

As set out in most annual reports is that executive pay structures are designed to 'attract, retain, motivate and align'. Therefore, pay should be enough to attract, retain and motivate the CEO and top management to improve the company's performance. The ideal model might therefore be relative performance evaluation, measuring against 'peer group' companies.

The Reality

The reality is that RemCo's must use their judgment to balance a variety of practical issues, different stakeholders, and external constraints. Tom's research, carried out with colleagues at London Business School, found that most investors and directors cited intrinsic motivation and personal reputation as key motivators for CEOs, suggesting that financial incentives are a lesser part of the overall picture.

Tom asserted that, despite intrinsic motivation, financial incentives still affect behaviour, as suggested by clustering around thresholds and maxima. They provide a performance focus that is a key indicator of effective management. Furthermore, the stakes are high. Over the last 25 years, incentives have increased from around one third to three quarters of the reward package.

Over the same period, the number of measures and the probability of payout have increased. This has raised both the importance and the complexity of incentive pay, and has put increased pressure on the internal systems within organisations. And although incentive pay is ostensibly for performance, the increased weighting of bonus in the total package means it is now far less acceptable (to executives) for a bonus to be zero, even if the company has performed badly.

Incentive Packages

Incentive packages have become a multi-dimensional compromise – something of a battleground between competing interests. Most incentive packages therefore aim to balance fairness to executives with fairness to shareholders and other stakeholders.

This entails striking a balance between rewarding inputs and rewarding outcomes. CEOs tend to prefer input related metrics which are more controllable, and which the data shows pay out higher amounts on average. Shareholders focus on output related metrics which have a greater link to their own return on investment. Package design therefore becomes an exercise in managing multiple stakeholder perspectives.

In terms of **Alignment with Value**, the two most common measures used are Earnings Per Share and Return on Capital. Each has its problems. Earnings per share can encourage over-investment and acquisitiveness, Return on Capital can discourage investments even if they add value. A whole industry has grown up aiming to come up with better measures to align executive reward with investor interests, hence the development of measures such as Economic Profit (EP). However, in practice, lack of alignment with management reporting frameworks, historic balance sheet issues and adjustment protocols often derail EP. The more complex financial metrics tend to get lost in a world of adjustments. A measure such as Economic Profit requires a massive effort to manage and to explain both to executives and to wider stakeholders.

Relative TSR

Relative TSR based on robust peer group selection should be the answer. It gives a measure of the relative gain (or loss) to shareholders over time vs comparable investments, and it therefore provides an indication of how well a senior executive team has performed.

The measure falls down on the selection of a peer group. It can be very difficult to find a group of companies sufficiently alike to produce a robust comparator group. For example, BHP's business is 75% mining and 25% gas. Tesco is 85% food retail, 15% general retail. There are no other companies with similar profiles. Both companies created customised indices to benchmark their companies against the sectors that made up their businesses. Both eventually abandoned the practice as the law of unintended consequences proved inviolable.

Peer group indices require a considerable amount of adjustment, calculation, and human intervention. Maintaining the index becomes a job in itself. So again, these measures build complexity into the system and place additional pressures on the reward infrastructure.

Tom drew a distinction between **Judgement vs Discretion.**

- **Judgement** involves making an interpretation of an input to a formula, e.g. an adjustment to a financial metric for a transaction. The formula still applies but judgement is applied in its application.
- **Discretion** means that the formula is over-ridden. Discretion is applied outside the formulaic outcome. For example, adjusting a bonus outcome because of a health and safety incident.

Judgement should refer back to the original intent of the measure and the targets set. Discretion should look at the overall fairness of an outcome, taking account of all the relevant circumstances. For discretion to be acceptable to shareholders requires balance (both positive and negative factors are considered), consistency (the adjustments are applied consistently over time and across measures), and transparency (investors see how the process works, and were informed before the event that discretion could be applied).

Further Reading

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

Scur, D., Sadun, R., Van Reenen, J., Lemos, R. and Bloom, N. (2021). *The World Management Survey at 18: Lessons and the Way Forward.* National Bureau of Economic. **https://www.nber.org/system/files/working_papers/w28524/w28524.pdf**

Reducing The Risk

VIDEO SUMMARY

ALAN GILES is Chairman of The Remuneration Consultants Group, Senior Independent Director and RemCo Chair of Foxtons plc, and a Non-Executive Director of Murray Income Trust plc. He is also an Associate Fellow of Saïd Business School, University of Oxford, and an Honorary Visiting Professor at Bayes Business School, City, University of London, where he is Deputy Chair of the Advisory Board of the Mergers & Acquisitions Research Centre. Alan has extensive retail sector experience at both Company Chair and CEO level. He was also a non-executive director of the Competition & Markets Authority until March 2019, having been a non-executive director of the Office of Fair Trading from 2007.

Alan Giles pointed out some practical steps that companies might take to reduce the inherent risk from using financial measures in performance plans and to prepare better for any reactions:

- Make sure you have a joined-up approach between the Remuneration Committee and Audit Committee
- Have the Audit Committee meeting before the Remuneration Committee so that any reservations about the numbers have been thrashed out before a follow-on discussion on the link to reward
- Have the Audit Committee Chair on the Remuneration Committee, or at least in attendance for that discussion
- Some RemCo Chairs also favour having the CFO in attendance, despite their being a probable beneficiary
- Think about how you are going to deal with situations where the management experience might differ substantially from the investor experience.
- If investors have done well, they are less likely to complain about incentives paying out, even if management have done little to earn them. Conversely when the market or currency or commodity prices go against you, no matter how skilfully management have coped with those factors, paying out incentives is frowned upon by shareholders.
- The strength of reaction from shareholders will depend heavily on how much they trust the Committee Chair and members. Your previous reputation with investors will colour how they react. If you are a 'serial offender', there won't be much trust and any actions you take will be viewed through a sceptical lens.

WATCH TOM'S PRESENTATION HERE

WATCH TOM AND ALAN'S DISCUSSION HERE

Discussion and Conclusions

One of the key differences of opinion between directors and investors may be that directors think the market for CEOs is tough and so it is necessary to pay to get the best. Investors are sceptical, think that good CEOs are easier to come by and tend to believe that CEO pay is too high.

Investors don't like executives to make money when they perceive the value of their investment has gone down. Shareholders therefore don't like discretion when they feel an agreed formula linked to value is being overridden.

The main beneficiaries of the increase in incentives from a third to three quarters of total reward have been the CEO s and senior executives. The greater focus on 'pay for performance' has provided the justification for an overall increase in CEO pay. At the same time, it has placed a huge strain on the corporate governance processes that are required to manage the system.

Restricted shares are often suggested as a better way of aligning management interests with those of shareholders. However, at a more visceral level, investors tend to feel it's unfair for management to have a windfall from things beyond their influence – like a very strong market (in which the company may have underperformed), favourable currency movements, and help from significant changes in commodity prices.

Discussion and Conclusions

This presentation and the subsequent discussion highlighted the age old 'agency problem' in which the interests of the shareholders and the managers of the business do not always align. The rise in the proportion of senior executive reward based on incentive payments, together with the overall increase in executive pay, has raised the stakes. Debates about executive pay have become a battleground between competing interests. Attempts to design elegant solutions to resolve this conflict, using complex formulas aimed at being fair to both shareholders and executives, have largely failed. This may be because the effort involved in maintaining these systems creates a significant administrative burden to manage and communicate. By driving variable pay so high, we have created an infrastructure which has stretched the ability of organisations' internal systems to cope.

Towards the end of the discussion the subject of ESG measures came up. This inevitably adds yet another layer of complexity to the assessment of executive performance. Using financial measures in incentive plans isn't always clear cut and there is plenty of scope for controversy. But we are moving into a world where there is going to be an increased component of non-financial measures in our reward plans. So it is advisable, wherever you can, to use measures which can be quantified and validated against some external (or credible internal) data source where the Committee can take greater comfort from independent assurance.

This will be the topic of the third session in our Performance Trilogy. We will return to this debate on 26 May 2022, when Alex Edmans will provide further insight into his major research on ESG and non-financial performance measures.

Measuring Financial Performance

Alex Edmans Professor of Finance, **London Business School**

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.