METRICS RE-LOADED

EXAMINING EXECUTIVE REMUNERATION PERFORMANCE MEASURES
The High Pay Centre is an independent non-party think tank established to monitor pay at the top of the income distribution and set out a road map towards better business and economic success.

We aim to produce high quality research and develop a greater understanding of top rewards, company accountability and business performance. We will communicate evidence for change to policymakers, companies and other interested parties to build a consensus for business renewal.

The High Pay Centre is resolutely independent and strictly non-partisan. It is increasingly clear that there has been a policy and market failure in relation to pay at the top of companies and the structures of business over a period of years under all governments. It is now essential to persuade all parties that there is a better way.

The High Pay Centre was formed following the findings of the High Pay Commission. The High Pay Commission was an independent inquiry into high pay and boardroom pay across the public and private sectors in the UK, launched in 2009.

For more information about our work go to highpaycentre.org

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The High Pay Centre would like to thank Lord Sainsbury who has funded this research.
## Contents

4  1 Preface

5  2 Summary findings

9  3 The long term measures  
   Fig. 1. Measures by market cap – all companies  
   Fig. 2. Measures by market cap – UK  
   Fig. 3. Measures by market cap – France  
   Fig. 4. Measures by market cap – Germany

12  4 Why choose relative TSR?  
   4.1 Shareholder value  
   4.2 Alignment with shareholder interest  
   4.3 Objective measure

15  5 Earnings per share

17  6 Short term measures  
   Fig 5. Overlap of short/long performance periods

20  7 Non-financial measures

23  8 UK disclosure of performance measures

20  9 Shareholder approval of performance measures

23  10 Performance measures and financial reporting standards

### Appendices

20  Reasons for choosing TSR – examples

23  Performance Measure Glossary

23  Methodology
Fifteen years ago everyone agreed. High pay could be justified if it corresponded to good executive performance. So the discovery that high levels of performance related pay have not delivered equivalent performance\(^1\) raises questions about the future of remuneration policy at our largest companies.

“In some corners of corporate Britain pay for top executives has become so divided from performance that it cannot be justified”

Simon Walker Director General of the Institute of Directors February 2015

So what should this performance look like if the misalignment which is still evident after fifteen years of pay-for-performance is going to be addressed?

In this, the latest in a series of publications on the subject of performance related pay, we look more closely at the way in which this commonly accepted mantra of “pay for performance” is translated into practical ways of measuring performance for executives at top listed companies.

Variable pay schemes such as annual bonus schemes and long term incentive plans are universally used by large listed companies to deliver pay for performance. Such schemes invariably use corporate financial performance measures. The use of such measures is premised on the assumption that it is appropriate to use collective corporate performance to inform individual rewards. Having accepted this assumption companies and shareholders wishing to adopt performance related pay schemes require the performance being measured to be quantifiable. Financial accounting measures have been seized upon as the lingua franca most able to serve this purpose.

This report looks at which measures are being used by companies and contrasts UK measures with those applied in Germany and France and we explore further the rationale used by companies for using the most popular measure. ■

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\(^1\) Executive remuneration in the FTSE 350 – a focus on performance related pay October 2014. A report for the High Pay Centre from Income Data Services
2 Summary Findings

> Our findings indicate that shareholders are prepared to tolerate continued use of earnings per share (EPS) and total shareholder return (TSR) for at least the next three years despite the evident mis-alignment over the long term between pay based on these measures and actual corporate performance.

> Many UK companies choose to provide better disclosure of future performance measures in the implementation report than in the future policy table. The reasons seem clear. The future policy table disclosure is subject to a binding shareholder vote. The implementation table disclosure is not.

> Non financial metrics are leading to perverse annual incentive outcomes.

> The financial statements produced in accordance with legally mandated financial reporting standards do not form the basis for paying management at most companies.

> A significant proportion of companies using EPS as a pay performance measure are failing to disclose whether they use an adjusted or statutory measure.

> Relative TSR continues to be the dominant performance measure across the sample however unlike the UK or France, a majority of German companies use absolute measures and not relative measures.

> The proportion of companies using a single financial performance measure for long term incentive awards is higher in Germany than in France or the UK

> Companies see no problem using the same financial measure to measure both short term and longer term performance.

> None of the UK companies in the sample disclosed targets for all their variable pay schemes in advance of the shareholder vote. The new UK regulations allow pay targets to be withheld and all companies take advantage of this permission.
High Pay Centre

3 The long term performance measures

The most common financial measures reported for long term schemes intended for use over the next three years by companies in our sample are Relative Total Shareholder Return (TSR) and Earnings Per Share (EPS). Relative TSR is also the dominant measure when set against the market value of ordinary voting shares outstanding at the year end prior to the most recent AGM.

The most common financial measures reported for long term schemes intended for use by UK companies over the next three years are Relative Total Shareholder Return (TSR) and Earnings Per Share.

Relative measures are used by 75% of UK companies in the sample compared to 46% of German companies and 52% of French companies. TSR is the measure used by all companies with a relative measure except for a single company which uses relative sales.

The picture changes when French companies are viewed in isolation. The predominant financial measures reported for this group are profit measures although earnings measures which are calculated per share are less common. Several measures used outside France were not used by any French company.

*Companies in our sample represent Euro 3398bn in market capitalisation (aggregate yr-end fig). Conversion to Euros at balance sheet date exchange rate.
**figure 2** Financial performance measures against market cap*  
**UK companies**

*These figures are relevant to the latest year end date prior to shareholder approval of future remuneration policy

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**figure 3** Financial performance measures against market cap*  
**French companies**

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*These figures are relevant to the latest year end date prior to shareholder approval of future remuneration policy
in the FTSE Eurofirst 100 including Capital Strength (in the guise of a core tier 1 ratio measure), Return on Invested Capital (ROIC), Growth in Asset Value, Cost Income Ratio, Economic Profit, Loan Loss Ratio, Return on Risk-Weighted Assets (RoRWA), and Dividend level.

Relative TSR is far less prevalent amongst German companies than amongst UK or French companies. Part of the reason for this difference may be to do with the differences in disclosure. Total shareholder return is not a term that appeared anywhere in the English language disclosure of performance measures at the German companies in our sample however the typical description of share price measures is not explicit and allows for the possibility that at least some of those companies categorised as using share price are in fact using TSR. Operating profit was the profit measure of choice for German companies and was the only profit measure reported.

Measures used outside Germany but not used by German companies in the FTSE Eurofirst 100 were Return on Equity (ROE), cash flow, loan loss rate, RoRWA, economic profit, operating margin, cost income ratio, growth in asset value, and ROIC.

The majority of companies make use of multiple financial performance measures in their long term schemes however looking at German companies in isolation this situation is reversed. A majority of the German companies in the sample employ a single financial measure for their long term performance scheme.
A majority of German companies use only absolute measures when applying financial performance conditions to awards under long term incentive schemes. Relative TSR and relative share price are the only relative measures used and are used by 46% of the German companies in the sample.
4 Why choose relative TSR?

Under the new UK remuneration regulations companies are now obliged to report their reasons for choosing the performance measures they will apply as part of their future remuneration policy.

“in respect of any component falling within paragraph 26(d) (i)–(iii), an explanation of why any performance measures were chosen and how any performance targets are set;”

Schedule 8 Part 4 Directors Remuneration Policy Para 27(a)

Many companies clearly do not comply. There is no room for interpretation here. The description must be in the notes to the future table. Several companies that provided an explanation failed to address each measure used and provided a generic statement for their multiple measures.

Amongst those companies that did provide an explanation the quality of explanation provided was variable. With regard to the most popular measure, relative TSR, four themes emerge.

The most prevalent is that TSR measures reflect the creation of shareholder value. Several companies also cited alignment with shareholder interests as their reason for using TSR. Comparability, objectivity or ease of use was also stated as a reason for choice of a TSR measure. Finally explanatory statements often avoid direct reference to the measures used but instead cite alignment with corporate strategy or group financial KPIs as the reason for choosing the pay performance measures (although companies would hardly be expected to make a statement to the contrary).

4.1 The shareholder value explanations

Relative TSR out-performance may still lead to an absolute loss in investment terms (and therefore a loss of shareholder value as commonly understood). But very few of the “shareholder value” explanations explain why relative TSR performance was chosen as opposed to absolute TSR performance. None of the companies explaining choice of TSR in the context of shareholder value provide a definition of shareholder value. Competition for investors is the distinguishing feature of explanations which address why relative TSR was chosen rather than absolute. None of these explanations make reference to the possibility of absolute investment loss coinciding with relative gain.

4.2 The alignment explanations

The assumption inherent in this category of explanations that a performance measure of TSR will deliver alignment of executive pay with shareholder interests must surely now be open to question.

The recent report by Incomes Data Services for the High Pay Centre drew on historical data to examine the relationship between directors pay for FTSE 350 companies and selected corporate performance measures including TSR.
The Incomes Data Services analysis of LTIP and TSR data for FTSE350 companies between 2000 and 2013 failed to find a significant correlation between LTIP rewards (represented by the vested value of LTIP awards reported in the year following the end of each three year TSR performance period) and TSR performance (represented by each three year change in TSR).

It is notable that the only UK company in the sample to report using absolute TSR rather than relative TSR makes no distinction between the two in its explanatory statement for choice of performance measure.

The explanations which depend on alignment also fail to adequately address another difference in the risks faced by shareholders and executives. Shareholders face the risk of absolute loss as well as relative loss. Executives do not face absolute loss if they do not buy their share awards. For example it has become common practice to “roll-up” notional dividend on shares which are subject to performance measures. Without subscribing for shares, it is difficult to see how this practice aligns with the investors’ experience.

So the assumption that relative TSR aligns executive interests with shareholders may be inappropriate in the first instance.

4.3 The objectivity/ease of use explanations

Relative TSR calculations are sensitive to underlying assumptions. These assumptions involve the use of discretion. Who uses this discretion and how, is not always evident from disclosure. The variety of assumptions that inform the different methodologies for calculating relative TSR across companies in our sample suggests that TSR is not as objective a measure as some explanations assert.

Amongst our sample companies there was a good deal of variation in the method for calculating relative TSR.

**Variance in assumptions disclosed for awards subject to TSR measure**

a) Average of closing daily prices or mid price of best bid and offer prices at close

b) Weighted average of Return Index at start and finish of performance period or weighted median c) For calculation of start and finish share prices for TSR calculation, companies use different weighted average periods including the first and last twelve months in the performance period and the first and last 3 months in the performance period

d) Choice of comparator group. Comparator groups ranged from 5 companies to 100 companies. Some companies use market cap indices whilst others use a sector specific peer group. Some companies make use of weightings in creating their comparator index whilst some do not.
e) Performance period. For some companies the TSR performance period is aligned with the announcement of results, for others it is financial year ends or year to date from grant of LTIP award.

f) Companies also have discretion over choice of currency used for TSR comparison.

g) TSR calculated on a per annum basis, or on a compounded basis

Rights issues by the company itself or by a constituent of the comparator group during the TSR performance period, require further assumptions to be made. For example the theoretical ex-rights price calculation that forms part of the calculation to adjust TSR for a rights issue might assume the sale of rights by investors to fund participation in the issue, but may also assume borrowing at a specific rate of interest.

Subjectivity is present throughout the variable pay process. Discretion is exercised when choosing the performance metric and again when choosing how to calculate the performance metric.

Discretion is exercised again when the performance pay is accounted for. The fair value calculation which determines the expense recognised in the accounts for share based awards at date of grant is itself an estimated figure based on the outcomes from a binomial model and simulations such as the “Monte Carlo” simulation.

The protection which shareholders have against manipulation of the figures which inform financial performance measures comes from an independent audit. In fact a surprisingly high percentage of audits are questionable. Over 40% of audits of systemically important financial institutions were reported to contain deficiencies by the International Forum of Independent Audit Regulators (IFIAR), the body responsible for inspecting auditors work, in its report on a 2014 survey of audit inspection findings. To be deficient according to IFIAR standards the audit firm did not obtain sufficient audit evidence to support its opinion. A deficiency may also indicate a failure to identify or address a potentially material error in application of an accounting principle.

Despite this sensitivity to the choice of calculation methodology, several companies base their choice of TSR on the ease with which TSR measures can be understood and compared. For example one company states that “Relative TSR has been chosen as the most appropriate measure as it allows for an objective external assessment over a sustained period on a basis that is familiar to shareholders”.

Some companies do not disclose the chosen calculation methodology in their annual report. For example one company in the sample states that “The calculation methodology for TSR, EPS and ROIC, and the components of the TSR comparator groups, are set out in the 2013...”
Notices of Annual General Meetings, which can be found on the company’s website.”

Just a single UK company in the sample adopted an absolute measure of TSR as part of its forward looking remuneration policy whilst every other company continues to measure total shareholder return relative to a comparator group. ■
5 Earnings per Share (EPS)

An earnings related measure will likely be used by all UK companies in the sample to measure performance for the purposes of informing directors’ remuneration in the next three years. Carefully worded disclosures which avoid a firm commitment to the measures disclosed as part of future policy, particularly with regard to annual bonus measures, prevent a more positive assertion.

With the exception of relative TSR, EPS is the most significant financial measure of long term performance reported by companies in the sample (see Fig.2) however even amongst UK companies that do not report an earnings or profit measure as a long term performance condition, all report the use of EPS as a short term performance measure. None of the companies in the sample report the use of TSR as a short term measure.

It is widely recognised that all measures have flaws and the use of multiple measures is an attempt to address the risks involved in dependence on a specific measure. Earnings based measures fail to take account of the capital that is required to generate the earnings in the first place. Two different companies could score equally well on an earnings measure despite one having significantly less equity than the other. The efficiency with which the two companies manage the invested capital is lost if the earnings based measure is used in isolation. Earnings measures are notoriously open to manipulation.

Here is what Tesco’s auditors PwC had to say about income recognition in the 2013 annual report.

“We focused on this area because of the judgement required in accounting for the commercial income deals and the risk of manipulation of these balances”

The EPS measure reported by our sample companies was invariably an adjusted measure. This lack of consensus on what constitutes an accurate earnings figure is reflected in IFIARs 2014 survey of inspections by public company auditors which found a high level of audit inspection deficiencies with regard to revenue recognition.

Despite the risk of bias in revenue recognition 18% of the UK companies in the sample choose to use an earnings or profit related measure as the sole group annual financial measure. Amongst the sample companies 10% choose to use an earnings or profit related measure as the sole group long term financial measure. It is not only the numerator for this measure which is sensitive to the choices made when adjusting away from the statutory earnings measure. The denominator is impacted by share capital changes, most notably the repurchase of shares, which has become increasingly common and which has the effect of improving the EPS figure without any necessary improvement in a company’s fundamentals.
The measure used for the Earnings element of the LTIP performance measure and the annual bonus measure is an adjusted earnings measure. To arrive at this figure the company takes the basic earnings figure which is reported in compliance with legally required financial reporting standards (IFRS) and adds back one-off items such as exceptional items and restructuring costs.

The difference between the IFRS reported figures and the adjusted figures as used for pay calculations can be significant. For example, the IFRS reported figure (net profit attributable to owners of the parent) for the year 2008 was negative (£48.5m). The figure used to inform the 2008 annual bonus was the adjusted headline figure, a positive earnings figure of £45.6m.

These cross over measures can be high yield measures for executives who can benefit from awards measured over single and multiple year periods on the same performance measure.

In the illustration below the same measure of earnings is used to inform the annual bonus pay outs during the 2008-2010 performance period for the LTIP and the subsequent LTIP pay outs at the end of the three years.

**figure 5** Cookson plc Earnings based incentive pay outs to executive directors 2008-2010
7 Non-financial measures

It has become increasingly common to find group non-financial measures included in the matrix of measures that now inform variable executive pay although application of group non-financial measures to annual bonus remains a rarity.

Amongst our sample UK companies nearly twice as many companies state their willingness to use a non-financial annual bonus measure as companies that do not reference such measures in their remuneration disclosures. Measures such as personal business objectives or strategic objectives have been excluded from the non-financial category and only measures that were group non-financial measures have been included. Operational measures such as market share have also been excluded where these are disclosed in sufficient detail.

As with long term financial measures disclosure of non-financial measures is often clearer outside of the future remuneration table than inside the table. For example one company’s future policy table included the statement that

“the committee may introduce non-financial measures in the future”

In an adjacent column it was stated that

“the Committee will also consider personal performance and the quality of results in terms of both business results and leadership, including corporate social responsibility and progress against the delivery of USLP goals”.

The inclusion of the column which mentions corporate social responsibility was explained as follows:

“This column does not form part of the binding policy report. It is intended to provide additional contextual information for the reader”.

Non-financial metrics tend towards a focus on stakeholders other than shareholders, for example employee motivation, health and safety and customers.

The emergence of non-financial metrics validates stakeholder interest and is to be welcomed, however this welcome should be accompanied by caution. Clearly employees or customers are in a different position to shareholders and the reward or service received from a company. Non financial pay performance metrics assume the protections afforded by these contractual relationships are inadequate. Once introduced, the difficulty lies in ensuring that what is being measured does not become detached from the reality which stakeholders experience.

Bankers’ bonuses

Following the financial crisis bankers’ bonuses have become a lightening rod for concerns over the extent to which executive pay reflects performance.
Public perception of bankers’ behaviour is coloured by a constant feed of negative media. Bail Outs/LIBOR/Small Business Lending/PPI/Capital requirement tests and most recently tax avoidance.

Further media attention on problems in the banking sector came on 6th November 2014 when the Competition and Markets Authority announced that it would be conducting an investigation into competition in the UK retail banking market. The announcement confirms a provisional decision to explore the lack of competition in personal current account and SME retail banking earlier in the year.

Amongst the principal concerns being addressed by the probe is the degree of control over the personal account market exercised by the Big 4 high street banks. Between them Lloyds, Barclays, RBS and HSBC control over 75% of this market.

Alex Chisolm, Head of the CMA, stated that

“The market is not working well for the public. Many customers are dissatisfied by the banks and they find it difficult to compare the charges”

So the public could be forgiven for assuming that customer satisfaction appears to be an area where corporate performance is below the expected standard.

All the major retail banks included a measure of customer satisfaction in the metrics that informed 2013 executive bonuses. All the banks made annual incentive awards and three of these banks paid more in bonuses to executive directors than in the prior year.

So how to reconcile public statements that bank customers are dissatisfied with payment of bonuses based on customer satisfaction?

Contrast the CMA statement with the bank’s own views on customer relationships.

Barclays - explanation for the 2013 FY bonus includes the statement that “Data shows reputation of and trust in Barclays is improving” whilst Lloyds Banking Group–remuneration report includes the statement “Further reductions in the number of customer complaints”. The HSBC remuneration report cites “lower customer redress charges”.

So why the difference?

The CMA’s assertion that retail banking customers are dissatisfied with the service they receive is drawn from the results of a market study published in July 2014. ² The study into the personal accounts market cites data from the banking regulator the Financial Conduct Authority (FCA) in support of its assertion that customers are dissatisfied. The FCA collates and publishes complaint data provided by the banks themselves. This data is a matter of public record.³

The banks however draw their conclusions from the metrics they

use to measure performance with regard to customer satisfaction.

It is notable that the explanation given by Barclays for its 2013 bonus with regard to customer satisfaction relies on a relative improvement in its metric. So too do the Lloyds and HSBC explanations. RBS disclosure appears to show that no bonuses were paid for 2013 however at least one director employed in FY 2013 received a bonus partly informed by customer satisfaction metrics measured in FY 2013.

The FCA data shows that for each of the Big 4 banks, customer complaints recorded were lower than in the previous year. This relative measure helps explain the positive statements in 2013 annual reports and the award of bonus elements based on customer satisfaction measures. Although a fall in complaints is supported by the year on year figures, there were rises in the number of complaints from first to second half 2012 to first half 2013 at HSBC and from 1st half to 2nd half 2013 at Lloyds.

None of the banks disclose an absolute measure for customer satisfaction and the award of a bonus intended to reflect superior performance for performing less badly appears counter intuitive. This is particularly the case where the choice of starting point for a comparison significantly affects the outcome.

With regard to the data for 2013 the FCA stated that

“The total number of complaints decreased by 15% to 2,479,029 in the second half (H2) of 2013 compared with the previous period (2013 H1). However, this is still 36% higher than the number of complaints in 2010 H2”.

None of the banks include a formal underpin for their non-financial metrics however they are all required to explain how discretion was used. The use of discretion to avoid payment of customer satisfaction bonuses for a year in which customer satisfaction levels were the subject of a formal regulatory investigation would surely have been judicious.

Without appropriate discretion being applied by remuneration committee members, adverse public sentiment will not be reflected in banking bonuses and seemingly perverse outcomes will follow.

3 www.fca.org.uk/firms/systems-reporting/complaints-data.
<table>
<thead>
<tr>
<th>Big 4 Bank</th>
<th>Non-Financial Customer KPI</th>
<th>2013 Exec Director Bonus</th>
<th>2013 FCA complaints total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barclays plc</td>
<td>2013 Annual bonus informed by a Balanced Scorecard and includes Customer &amp; Client sub-score for the retail bank. The KPI is called the “Relationship Net Promoter Score” and measures relative levels of customer advocacy.</td>
<td>2013 Executive Director bonuses were £1.7m for performance Jan-Dec 2013. Explanation for bonus includes the statement that “Data shows reputation of and trust in Barclays is improving”. Bonus total for Exec Dir up on prior year.</td>
<td>Barclays Bank plc 309494 Jul/Dec 13 370733 Jan/Jun 13</td>
</tr>
<tr>
<td>Lloyds</td>
<td>2013 Exec Director Annual bonus 50% informed by Balanced Scorecard which includes a customer service category amongst the fix measures used.</td>
<td>2013 Executive Director bonuses were £2.68m for performance Jan-Dec 2013. Explanation for bonus includes “Further reductions in the number of customer complaints, now down to 1.0 per 1,000 accounts, the lowest of any major UK bank”. PPI complaints are deliberately excluded from the measure used for bonus. Executive Bonus total higher than prior year.</td>
<td>Lloyds TSB Bank plc 256656 Jul/Dec 13 253735 Jul/Dec 13</td>
</tr>
</tbody>
</table>

- continues on page 20
<table>
<thead>
<tr>
<th>Big 4 Bank</th>
<th>Non-Financial Customer KPI</th>
<th>2013 Exec Director Bonus</th>
<th>2013 FCA complaints total</th>
</tr>
</thead>
<tbody>
<tr>
<td>HSBC</td>
<td>2013 Exec Director Annual bonus 40%- 70% (varies for each individual) informed by non-financial measures. However the most pertinent performance measure for customer satisfaction was the Return on Equity target, a financial measure, which was impacted by notable customer redress provisions.</td>
<td>2013 Executive Director bonuses were £2.9m for performance Jan-Dec 2013. Explanation of how annual bonus arrived at includes the statement that “the Group worked through legacy issues that have impacted the Group in terms of customer redress”. Ex Bonus total higher than prior year.</td>
<td>HSBC Bank plc 141084 Jul/Dec 13 186321 Jan/Jun 13</td>
</tr>
<tr>
<td>RBS</td>
<td>No annual bonus paid to directors serving during FY 2013. No disclosure in 2013 remuneration report of customer related performance measures applicable to 2013. 2012 annual report stated that “achievement of customer performance measures” formed part of one of five core objectives that informed annual bonus for 2013. The exact measure and the weighting were not disclosed.</td>
<td>2013 Executive Director bonuses were reported as £0.0m however an annual incentive award of £980,00 for which performance was measured during 2013 part vested in March 2014.</td>
<td>Royal Bank of Scotland plc 88518 Jul/Dec 13 101901 Jan/Jun 13</td>
</tr>
</tbody>
</table>
“This October, new rules will mean companies formally set, agree and implement executive pay policy with their shareholders. These changes will make reporting more transparent, so shareholders and investors are clearer about pay.”

Vince Cable, Secretary of State for Business innovation and Skills

There appears to be a greater degree of certainty about how much executives are paid and the basis for this pay than ever before. The binding vote on executive pay introduced in 2013 together with a raft of additional mandatory disclosure requirements seem to offer proper accountability, to shareholders at least for the sums being awarded to those at the top of UK business.

A closer analysis reveals a lack of certainty about the targets or even performance measures that will be used by companies in the next three years.

The Performance Measures used in this study are drawn from the content of each company’s future policy table as prescribed by the Large and Medium Sized Companies and Groups (Accounts and Reports) (amendment) Regulations 2013. Schedule 8 Para 26 (d)(i). (“the new regulations”)

The new regulations state that companies must provide a table showing each component of remuneration comprised in the directors’ remuneration policy and for each relevant component, a description of the framework used to assess performance including

“a description of any performance measures which apply”

Schedule 8 allows companies to withhold information about performance measures if the directors consider this information to be commercially sensitive however where information is withheld on these grounds particulars of and the reasons for the omission must be given in the report.

“Any requirement of this Schedule to provide information in respect of performance measures or targets does not require the disclosure of information which, in the opinion of the directors, is commercially sensitive in respect of the company.”

It seems clear that some companies are reluctant to disclose performance measures and all companies are reluctant to disclose performance targets despite the default company law requirement to make such disclosures.

None of the UK companies in the sample disclosed future annual bonus targets and the vast majority took advantage of the safe harbour afforded by the amended UK Companies Act for withholding disclosure of performance targets which the directors deem to be commercially sensitive.

8 Disclosure of performance measures

All but two UK companies reported that they had chosen not to disclose information in respect of performance measures on the grounds of commercial sensitivity. One company neglected to make a statement despite disclosures confirming that annual bonus targets were applied whilst the other company stated that no performance measures had been established for executive directors.

One company failed to disclose the performance measures intended for use in either long or short term incentive plans in its remuneration policy report.
9 Shareholder approval of performance measures

The new UK directors remuneration regulations introduced in October 2013\(^5\) prescribe particular disclosures for future remuneration policy. The regulations recognise that acting within the terms of approved remuneration policy is important. Directors are bound to act within the terms of approved remuneration policy. A payment outside the terms of the approved remuneration policy, for example, one based on performance measures not sanctioned by approved policy, could impose a personal liability on the directors.

Although many companies take advantage of the exemption provided in withholding disclosure of targets, most companies disclose performance measures. However many companies choose to provide better disclosure of future performance measures in the implementation report than in the future policy table.

The reasons seem clear. The future policy table disclosure is subject to a binding shareholder vote. The implementation table disclosure is not.

Language is looser and targets more likely to be unquantified in binding vote disclosures.

Example 1

Future Policy Table disclosure – forward looking – binding vote
“The performance measure to determine the vesting of the shares is chosen each year and is *typically* a financial measure such as EPS growth. Further details on the performance criteria for threshold and maximum vesting are disclosed in the Annual Remuneration Implementation Report on pages 68 to 70.”

Implementation Report disclosure – backward looking – advisory vote
Performance conditions for the Co-Investment Plan - CIP awards made in 2013 are subject to the performance conditions set out in the table below.

<table>
<thead>
<tr>
<th>EPS Growth performance (annual average growth over three year term)</th>
<th>Match awarded (number of matching shares awarded per investment share)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 3% RPI +3% 0.0</td>
<td>0</td>
</tr>
<tr>
<td>RPI +3% 1.0</td>
<td>1</td>
</tr>
<tr>
<td>RPI +4% 1.25</td>
<td>1.25</td>
</tr>
<tr>
<td>RPI +5% 1.5</td>
<td>1.5</td>
</tr>
<tr>
<td>More than RPI +% 1.5</td>
<td>1.5</td>
</tr>
</tbody>
</table>

\(^5\) The Large and Medium Sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013
Example 2

Future Policy Table disclosure – forward looking – binding vote
“demanding annual performance goals, which are based on the Group’s KPIs, in pursuit of the creation of sustainable shareholder value.”

Implementation Report disclosure – backward looking – advisory vote
“financial targets relate to earnings and cash flow”

Even where measures are included in the future policy table disclosures, details of how these measures are calculated are disclosed elsewhere in sections of the report not subject to a binding vote.

Example 3

Future Policy Table disclosure – forward looking – binding vote
Details of the calculations supporting this measure are set out in the Annual Report Remuneration

Implementation Report disclosure – backward looking – advisory vote
TSR is measured according to the return index calculated by Datastream and reviewed by the Company’s remuneration consultants. TSR is measured on the basis that all companies’ dividends are reinvested in the shares of those companies. The return is the percentage increase in each company’s index over the three-year performance period. The opening and closing indices for this calculation are respectively the average of the index numbers for the last quarter of the final year of that performance period - this methodology is employed to reflect movements of the indices over that time as accurately as possible. A local currency basis is used for the purposes of TSR measurement.
10 Linking performance measures and the accounts

The principal legislation governing reporting in the UK is laid down in the Companies Act 2006, which incorporates the requirements of European law. European law now requires that all listed European companies, including all the companies in our sample, report under International Financial Reporting Standards (IFRSs). IFRSs are accounting standards and interpretations published by the International Accounting Standards Board (IASB).

In theory then all the large listed European companies in the sample could be expected to report to the same financial reporting standards and therefore have comparable performance measures for their performance related pay schemes.

An analysis of the performance measures used by companies in our sample shows that this is not the case.

There is a disconnect between accounting standards and the way in which performance is accounted for.

Over 70% of the UK companies reporting use of an EPS pay performance measure adjust away from the statutory measure of earnings. The remaining companies all fail to confirm in their disclosures whether the EPS measure used for their long term scheme is an adjusted or statutory measure.

This suggests that companies have no faith in accounting standards to reveal the proper basis for paying management

Generally accepted accounting practice in the UK (UK GAAP) is the body of accounting standards and other guidance published by the UK Accounting Standards Board (ASB). The ASB is part of the Financial Reporting Council, an independent regulator funded by a levy on listed companies.

IAS 33 is the standard for reporting EPS. (IFRSs are still sometimes referred to by their original name of IAS’s). The stated aim of IAS 33 was to prescribe principles for determining and presenting earnings per share amounts to improve performance comparisons between different entities in the same reporting period and between different reporting periods for the same entity.

So companies adjusting away from this standard are not only using a different standard for paying management than that which applies for reporting to shareholders, but also risk undermining the stated purpose of the standard – namely comparison.

To mitigate this risk, companies are required to disclose the amounts used as the numerators in calculating IFRS EPS, and a reconciliation of those amounts to profit or loss (attributable to the parent).

However there is no explicit or implicit requirement to report the numerators used in calculating an EPS pay performance measure where this is different to that used elsewhere in the report and not all companies clearly state whether or not the EPS measure used for pay is the same as that used elsewhere in the report.

© IAS 33 source
## Appendix 1: Reasons for choosing TSR

### 1.1: Failure to state clearly why TSR was chosen

<table>
<thead>
<tr>
<th>Company</th>
<th>HPC analysis of relevant disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Astrazeneca</td>
<td>There is a general description of why performance targets were chosen but nothing specific to TSR.</td>
</tr>
<tr>
<td>BAT</td>
<td>The chairman of the remuneration committee asserts his belief that continued use of relative TSR is justified but no reason is given for this assertion. A further statement justifies the method of calculation but not the use of the measure.</td>
</tr>
<tr>
<td>BSkyB</td>
<td>The benefits of a TSR measure are explained in the context of financial KPI disclosure in the strategic report however no explanation is provided in the remuneration report and no mention made of why Relative TSR was chosen as a performance measure.</td>
</tr>
<tr>
<td>Centrica</td>
<td>A statement is provided in the strategic report that the board believes TSR is a valuable KPI to assess performance in delivery of shareholder value. No explanation is provided for why the board believes this to be the case and no explanation is provided for why Relative TSR was chosen for the LTIP.</td>
</tr>
<tr>
<td>Experian</td>
<td>No description provided in the annual report of why performance measures were chosen. This is a Jersey incorporated company and the requirement to provide a description did not apply.</td>
</tr>
<tr>
<td>Reed</td>
<td>There is a statement that the measures are chosen to support strategy but the only reference to the TSR measure is indirect and is an assertion that the measure was chosen in order to focus on returns to shareholders. The relative nature of the measure is not mentioned.</td>
</tr>
<tr>
<td>Shell</td>
<td>TSR described as “Assessment of actual wealth created for shareholders”....and disclosed separately “measures which are selected because they are seen as key outcomes of the delivery of the strategy” however no description of relative TSR and no attempt to describe how relative TSR meets the strategic objective</td>
</tr>
<tr>
<td>Vodafone</td>
<td>Explanation that targets are based on company objectives but no rationale given for choice of specific measures.</td>
</tr>
</tbody>
</table>
1.2: Reasons for choosing TSR as a performance measure

1.2.1 Shareholder value explanations from remuneration reports

Anglo American  TSR measures to reflect the extent to which value is being delivered to shareholders

Diageo  Performance measures such as organic net sales, organic operating margin, relative Total Shareholder Return (TSR) and eps growth are key drivers of growth for the business that are aligned with the creation of shareholder value.

Rio  We reward executives for delivering shareholder value by using relative TSR as one of the measures for our LTIP.

Unilever  Unilever’s primary business objective is to generate a sustainable improvement in business performance through increasing the underlying value and volume of sales while steadily improving core operating margins and cash flow. The measures chosen for the annual and long-term incentives support the delivery of this objective. Performance measures focus management on the delivery of a combination of top-line revenue growth and bottom-line profit growth that Unilever believes will build shareholder value over the longer term. Total shareholder return measures Unilever’s success relative to peers.

SAB Miller  The company’s key strategic priorities aim to deliver a higher return to shareholders than our peers. Accordingly, these same strategic priorities determine the performance measures and targets for both the short-term and long-term incentive plans.

1.2.2: Alignment

BT  Share price performance measures, to reflect the ultimate delivery of shareholder returns which may, for example, include TSR. This promotes alignment between executive director reward and shareholder value creation.

Compass  The third performance measure of TSR provides direct alignment between the interests of Executive Directors and Shareholders.
Lloyds  We believe these measures capture risk management and profit growth and appropriately align management and shareholder interests.

Prudential  Relative TSR was selected as a performance measure because it focuses on the value delivered to shareholders – aligning the long-term interests of shareholders with those of executives.

Rolls Royce  The TSR performance measure aligns interests with shareholders by rewarding TSR out-performance.

1.2.3: Objectivity

BHP Billiton  Relative TSR has been chosen as the most appropriate measure as it allows for an objective external assessment over a sustained period on a basis that is familiar to shareholders"
## Performance Measure Glossary

<table>
<thead>
<tr>
<th>Measure</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset Value Growth</td>
<td>Value growth is the growth in the value of regulated and non-regulated assets including goodwill plus dividend less net debt, on a per share basis.</td>
</tr>
<tr>
<td>Capital Strength(tier 1 ratio)</td>
<td>Core Tier 1 Capital is broadly tangible shareholders’ funds less certain capital deductions</td>
</tr>
<tr>
<td>Cash Flow</td>
<td>Various measures used the most common of which are; free cash flow (measures the amount of cash a company has generated over a period after all outgoings such as dividend, debt payments, tax, operating costs, capital expenditure); and net cash from operating activities (cash flow reporting is usually segmented into operating activities, investing activities and financing activities)</td>
</tr>
<tr>
<td>Cost efficiency ratio</td>
<td>The cost efficiency ratio is defined as total operating expenses divided by net operating income before loan impairment charges and other credit risk provisions</td>
</tr>
<tr>
<td>Dividend</td>
<td>Measures the amount of profit which directors decide to distribute to shareholders from current or retained earnings</td>
</tr>
<tr>
<td>Economic Earnings</td>
<td>Economic earnings are defined as the change in economic equity in a given period, adjusted for capital inflows and outflows, including dividend payouts and share buy-backs.</td>
</tr>
<tr>
<td>Economic Profit</td>
<td>The difference between the revenue received from the sale of an output and the opportunity cost of the inputs used</td>
</tr>
<tr>
<td>EPS</td>
<td>Profit divided by the number of outstanding ordinary shares</td>
</tr>
<tr>
<td>Loan Loss Rate</td>
<td>The loan loss rate is quoted in basis points and represents total annualised loan impairment divided by gross loans and advances to customers and banks held at amortised cost at the balance sheet date.</td>
</tr>
<tr>
<td>Profit measures</td>
<td>Various measures used which all calculate revenue less the cost of doing business. Operating profit (revenue...</td>
</tr>
</tbody>
</table>
Return on Assets
Total assets divided by debt expressed as percentage

Revenue or sales
The amount of money received during a specific period – the top line figure from which costs are subtracted to get measures of profit. Divisional sales figures, sales from new products or revenue from new business development often used.

ROCE
Earnings before interest and tax divided by total assets less current liabilities

ROE
Ratio of net group profit to shareholders equity

ROIC
Net income-dividends/total capital. Total capital = total equity plus total debt minus operating cash and investments

RoRWA/ROA
Return on Assets is the ratio of net income to total assets. Return on Risk Weighted Assets is used by banks. The value of each asset class is adjusted for risk to establish how much loss the capital could absorb. This adjusted measure of assets is then used as the denominator in the ROA calculation.

Share Price
Change in price of shares over a defined period

TSR
Return from share price appreciation plus dividends reinvested
Methodology

All the data used was drawn directly from the latest published annual reports (or overseas equivalent) for the companies in the sample. The sample comprised all UK, French and German constituents of the FTSE Eurofirst 100 in August 2014.

The choice of sample companies is not intended to influence or recommend any investment decisions and no attempt was made to reflect the weightings, free float calculations or other methodologies used by the index.

Market capitalisation is based on number of issued and outstanding ordinary shares at balance sheet date multiplied by closing share price at the relevant financial year end. The rationale for choosing this measure is that it represents the votable equity held by shareholders entitled to reject or adopt reported remuneration at the AGM of each company.

Companies report a plethora of performance measures within their remuneration report and we chose to focus on those measures which the company intends to use going forwards. For UK companies these measures should now be disclosed in the future policy table. For other European markets disclosure of whether a measure already in use for the financial year reported on will apply in future is often poorly defined. Where it was clear that no inference could be drawn about intended future use we used the assumption that measures that were in use during latest financial year to which annual report is relevant would continue to be used.

The performance measures which form the basis of the graphs were exclusively financial measures (operational and non financial measures were excluded). When identifying the performance measures for inclusion in the sample only measures for schemes using consistent performance measures over multi year periods were included. Multi year schemes where different objectives are applied annually were excluded.

Financial measures which are used to judge the appropriateness of an outcome against performance measures applied over the period of an award (sometimes called a financial underpin) have been excluded.