high pay centre

MADE TO MEASURE

HOW OPINION ABOUT PERFORMANCE BECOMES FACT

About the High Pay Centre

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.

The author: David Bolchover is a writer on management and the workplace. He is the author of three business books, the latest being *Pay Check: Are Top Earners Really Worth It?* (Coptic Publishing, 2010). He is on the advisory panel of the High Pay Centre. This report is based on interviews conducted between August and December 2014.

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Foreword

David Bolchover

In research for his 2005 book, “Blink”, Malcolm Gladwell found that 30% of chief executives (CEOs) of Fortune 500 companies were 6 feet 2 inches or taller, but only 3.9% of the American male population were a similar height.[1] Meanwhile, a 2013 study by Duke University and the University of California at San Diego revealed that the deeper the voice of the 792 male CEOs they listened to, the more they earned. To be precise, a decrease in voice pitch of 22.1 Hertz (Hz) translated into another $187,000 a year[2]

The temptation for many journalists has been to present these research items as a light and mildly amusing news item. But our interviews with a diverse range of eminent executives, academics and other expert commentators suggest that these statistics are a direct result of the great difficulty, if not impossibility, in measuring the contribution of individual executives in any precise way. In a world where judgement of performance is extremely subjective, image and perception become paramount.

The overwhelming consensus from these interviews casts serious doubt on any automatic attribution of apparent corporate success to the decisions or abilities of one executive, or to those of the relevant senior management team. Recent research by Incomes Data Services for the High Pay Centre[3] showed that the massive rise in executive pay in no way reflects a commensurate boost in corporate performance. This report calls into question whether those who believe in market principles should be satisfied even if it did. ■

[1] www.gladwell.com “Why Do We Love Tall Men?” (http://gladwell.com/blink/why-do-we-love-tall-men/)
[2] Evolution and Human Behavior, 11 April 2013, “Voice pitch and the labor market success of male chief executive officers”, (http://www.ehbonline.org/article/S1090-5138(13)00023-8/abstract?cc=y)
[3] http://highpaycentre.org/blog/new-high-pay-centre-report-performance-related-pay-is-nothing-of-the-sort

Summary

This report asks whether and how excellent company performance, and excellent individual senior executive performance, can be properly defined and measured. It therefore does not deal with high pay directly, but with the principal justification for high pay – namely, high performance. It closely examines the assumption that the demand for rare excellent performance in executives so far exceeds the supply of individuals able to provide that performance, that high pay becomes inevitable.

The report asks three questions in depth:

1 Are the CEO and/or other senior executives completely, principally, somewhat, scarcely, or not at all responsible for corporate performance?

2 If he/they are indeed largely responsible, how difficult would it be to find someone else to exert a similarly positive impact? If finding a replacement is very possible, then to what extent can we call that performance outstanding when it can be replicated by numerous others? Certainly, there are many people who perform their jobs with great efficiency and skill whom we do not elevate to superstar status, given the implicit assumption that they can be replaced relatively easily, notwithstanding their abilities.

3 In the event of what appears to be strong corporate performance, how often is this performance really as good as it looks at first glance? Should our assessment of performance be more focused on the long term? Should we pay closer attention to what is going on behind the financial figures, and take non-financial metrics into account when evaluating performance?

The main conclusions from our extensive one-to-one interviews, supplemented by the results of an Institute of Directors survey[4] commissioned by the High Pay Centre, were as follows:

Luck and circumstance often shape our perception of executive performance

A recurrent theme in our interviews was that many executives are seeing their own individual finances and reputation boosted just because they happen to have presided over a successful company that may well have achieved equivalent success without their presence at the helm. "The role of the CEO is often overstated" says Sir Philip Hampton, the chairman of RBS. "Many CEOs are in charge of operations which would run quite smoothly without their daily input."

Stripping out the effect of executive performance from other factors is not possible to achieve with any accuracy

Whatever one's opinion about the impact of CEOs, it will always remain just that - an opinion. It is impossible to isolate this impact convincingly from the many other factors which contribute to corporate performance. "Minds

[4] Poll of 1,089 IOD members in Dec 2014.

leap very quickly from outcomes to causal attributions," says Phil Rosenzweig, professor of Strategy and International Management at IMD Business School in Switzerland. "We are quick to say that a successful company has a brilliant, charismatic CEO, because we attribute success to the most visible person. The reality is much more complex."

CEOs are much more replaceable than their status and pay might indicate

Several interviewees claim that it is easier to replace incumbent CEOs than is often claimed. "They are not as rare as they make out," says Anthony Hilton, the veteran writer on business affairs and Evening Standard columnist. "We need to distinguish between aptitude and skill, on the one hand, and rare talent on the other." When asked what characteristics top executives need to possess, the response from interviewees was very varied. This question, not to mention related questions about how rare these characteristics are and whether a particular individual possesses them, is once again, highly subjective.

The difficulty of precise measurement presents a great opportunity to those inside the system

As an objective measurement of executive impact and replaceability is not possible, subjective judgements hold sway. In the safe knowledge that counter-arguments disparaging executive influence or rarity are also difficult to prove, those inside the system making these judgements clearly have a vested interest in emphasising the impact of senior executives and downplaying other factors. The status and pay of executives, and of those in the circles surrounding them, are bound to increase as a consequence of such an assessment. "I don't think judgement of individual performance is based on profound measurement," says Luke Johnson, the serial entrepreneur, private equity investor and Financial Times columnist. "It is much more about insider capture. The justifications habitually used are post-rationalisation."

Evaluation of corporate and individual performance becomes more reliable as time horizons lengthen

Although still imperfect, judgements based on longer-term horizons can at least make more allowances for the fluctuations of economic and market conditions. "When judging performance, time is the only real leveller," says Lord Wolfson, CEO of Next. "All of us have moments of extremely good luck and extreme bad luck, but in time that luck runs out." How much time is necessary to make a proper judgement is another issue of disagreement among interviewees.

Non-financial criteria can be a problematic means of measuring company performance

Many interviewees put forward the view that there are intrinsic difficulties with performance measures focusing on non-financial criteria, such as customer service or contribution to society at large. They felt that these metrics can be too easily manipulated, and that excessive focus on them can be detrimental to business performance. However, others disagreed, stating that only an emphasis on non-financial measures can reduce what they claim to be an unhealthy obsession with short-term financial performance. Indeed, a 2014 survey of more than a thousand members of the Institute of Directors, commissioned by the High Pay Centre, found that many executives place great significance on non-financial measures. Three quarters, for example, believe that "customer satisfaction" is a very important factor in measuring company performance – a higher number than for any other measure.

Box 1: Interviewees

Business leaders
Sir Philip Hampton, Chairman, RBS
Simon Wolfson, CEO, Next
Tim Martin, Founder and chairman, Wetherspoon
David Henderson, Special Adviser and former chairman, Kleinwort Benson
Sir Mike Darrington, former Managing Director of Greggs

Academics
Phil Rosenzweig, Author of “Halo Effect: How Managers Let Themselves Be Deceived”, Professor of Strategy and International Management at IMD Business School, Switzerland
Moshe Adler, Author of “Economics for the Rest of Us”, lecturer at Columbia University
Mike Bourne, Professor of Business Performance, Cranfield University School of Management

Investment managers
Robert Talbut, formerly chief investment officer of Royal London Asset Management and Chairman, Markets & Asset Management Committee, Investment Association
Abigail Herron, Head of Responsible Investment Engagement, Aviva Investors

Private equity investor
Luke Johnson, Chairman of Risk Capital Partners, entrepreneur and columnist, Financial Times

Remuneration consultant
Mark Hoble, Partner and leader of European Executive Rewards Practice, Mercer

Commentators
Ed Smith, Author of “Luck: A fresh look at fortune” and columnist, New Statesman
Anthony Hilton, Columnist, Evening Standard

Trade association representative
Daniel Godfrey, Chief Executive, Investment Association

Section 1: The impact of senior executives on corporate performance

Commentators regularly ascribe the entire financial performance of huge companies to the impact of one person. “He increased profits/turnover by x million or y% in the space of two years”, we are constantly told. But our in-depth conversations with leading executives, academics and other analysts suggest that people may often be too quick to focus on executive impact at the expense of the many other factors which contribute to overall corporate performance.

“Before we pay people a lot for doing what appears to be a good job, shouldn’t we first ask whether we are certain about the degree of their agency?” asks Ed Smith, the former professional cricketer, now a columnist with The New Statesman and author of “Luck: a fresh look at fortune”. “Even being aware of that question takes us quite far.”

Our interviews indicate that some executives do indeed doubt the power of their own influence in many circumstances, although these private reservations have not acted as a brake on the cult of the omnipotent CEO which has gained such a foothold within conventional wisdom over recent decades.

“Sometimes you just get lucky”, says Sir Philip Hampton, chairman of the Royal Bank of Scotland, and previously a senior executive at several blue-chip companies, such as Sainsbury’s and BT. “Perhaps you joined an industry at the right time, maybe you were promoted at the right time, and then the circumstances of your industry suddenly become favourable. Even if you are a half-wit, you are going to do quite well in this situation. So many financial incentives rely on luck, the evolution of markets, rather than on people’s contribution.”

Luke Johnson, the entrepreneur who grew Pizza Express and is now a private equity investor in a diverse range of companies as well as writing a business column for the Financial Times, holds a similarly sceptical view about the scope of the CEO’s influence in major companies. “It is a myth that one man (and normally, it is a man) is responsible for a large proportion of the outperformance of a large, long-established, institutionally owned plc,” he says. “Very often, the results owe more, for example, to an improving economy, or to a specific market in which the company operates which is doing particularly well, or to the strength of its existing brand, or to the fact that competitors are suffering for whatever reason, or to the research and development division which has come up with a new invention, and so on.”

What proves this point more than anything else to Anthony Hilton, longstanding observer of the business world and columnist for The Evening Standard, is the fact that so few CEOs who achieve superstar status at one company repeat the trick at another. “Look at Marc Bolland, for example”, he says. “He gets taken on by Marks & Spencer after seemingly turning round Morrisons, but there has been little improvement in its performance. There are so many intangibles that influence of the perception of the performance, such as external environment, colleagues or the state of the industry. People often think executives are great, but with hindsight it becomes obvious that other factors simply made them look good."

It would be difficult to argue that somebody heading a company of five people does not have a marked influence on how it fares. But the more people within the company, the more we can call into question the impact of the CEO. "All the successful companies I have been involved in have relied on a team effort," says Mr. Johnson. "That team might be hundreds of people, and the CEO generally follows recommendations from the many advisers working with him." As Sir Philip Hampton puts it, "the bigger the system, the more the system counts, rather than the person at the top of it."

The impact of senior executives is, Sir Philip believes, more doubtful in some industries than in others. "There are certain industries where macroeconomic factors are absolutely crucial, and way beyond the influence of any manager," he says. "If you are a mining business, for example, and you experience a sustained period when China is suddenly importing minerals like there's no tomorrow, without the world having developed the capacity to produce the volume to meet Chinese demand, then prices will inevitably rocket. And if the price of iron ore or zinc rockets, then you will make a ton even though you have made little contribution to the performance of that business."

However, the role of luck and circumstance in the perception of performance, and the resulting ramifications for executive pay, should not, in his view, necessarily concern us unduly. "You can never eliminate the element of mere participation in success and failure," he says. "You should try to mute that element as much as you can. But sometimes in life, you have to say "sometimes you are lucky, and sometimes you are not"."

Two interviewees took particular issue with the idea that executives are frequently judged and rewarded for results that have little to do with them, arguing that investors are already well aware of the many determinants of corporate performance. "Shareholders will expect a level of performance that is based on their view of the company," says Mark Hoble, partner and leader of the European Executive Rewards Practice at Mercer. "The strength of the brand or economic circumstances, for example, will be taken into account, and executives will have to exceed reasonable expectation if they are going to be judged to have done an excellent job. The idea that someone would say "you've done a good job but the brand has been great for 50 years, so we are adjusting your pay as a result", that to me is pretty distasteful."

Daniel Godfrey, Chief Executive of the Investment Association, a trade association for the UK investment management industry, takes a similar view. "The board and shareholders should be able to reach a sensible conclusion about how much value the management is adding," he says. "If I manufacture bottled water, and there's a problem with tap water in one particular year, it's obvious that I should be able to make good money in that year. The board should be able to strip out external factors and assess whether I have done better than my competitors who were in a similarly advantageous position."

Mr. Hoble accepts that executives "have less of a short-term impact in capital intensive industries" such as oil production and mining. But he nevertheless insists that they have a vital role to play in others, such as the retail or technology industries.

Indeed, Simon Wolfson, the CEO of the retailer Next, is certain that in his industry, no company can prosper without the right leadership: "In the short term a large business will run itself but in the long run a company's destiny relies on the person at the top," he says. "If you let things happen automatically, you will eventually fail because no formula lasts. Many think that being a CEO is like driving a car. You just get behind the wheel and drive a well-travelled road. In reality, the CEO must, to some extent, build the car, constantly adapt the engine, work out where the accelerator is, and decide between the many alternative journeys it might take."

While people may argue back and forth about the extent of executive influence on the performance of large, established companies, the very fact that such a debate is taking place among those with a wealth of high-level business experience suggests that any objective measurement of that influence is extremely difficult.

"Separating the impact of the CEO from all the other factors is probably impossible to do perfectly," says Professor Rosenzweig, author of the book "Halo Effect: How Managers Let Themselves Be Deceived", which investigates what he believes to be the many prevalent delusions obfuscating proper analysis of business performance. "The best we can do is imperfect."

Luke Johnson goes one step further, omitting the proviso "probably". "Isolating one person's discrete contribution to the success of a large undertaking which employs thousands of people is an impossible task," he says. "I just don't see how it can be done." ■

Section 2: The replaceability of top executives

We have seen that the impact of senior executives on corporate performance is open to serious doubt, and that, in any case, it appears impossible to prove this impact conclusively. But even if we were to accept that a CEO may have significant influence on company performance in certain circumstances, how difficult would it be to replace a person capable of such influence? Certainly, it would be difficult to make the rational case that any individual should be so highly regarded and paid a vast amount when their skills are very replaceable, no matter what their impact on company performance.

David Henderson, a former chairman and now special adviser for Kleinwort Benson and a non-executive director of several companies, is not alone in suggesting that the rarity of CEOs is frequently overplayed. “We are told that it’s supply and demand,” he says. “Supposedly, there is hardly anyone else who can do these jobs. We are told there is only one other person who can do a particular job, and he is on the other side of the world so we have to pay huge sums to poach him. Frankly, I find this incredible.”

The role of luck and other external factors may, of course, determine what we think about the replaceability of executives. The two issues of impact and replaceability cannot therefore be entirely disconnected. “It’s hard to say whether executives are talented when they are only there for four or five years,” says Tim Martin, the founder and chairman of the pub chain Wetherspoon. “Part of the definition of excellence is being in charge for ten or twenty years through several business cycles and putting in a good performance for all that time.”

The competition for rare talent in a free market is a frequent justification for high pay. But Moshe Adler, a lecturer in Economics at Columbia University in New York and author of “Economics for the Rest of Us,” thinks that this argument contains a fundamental flaw. “If it’s so easy to lure a CEO away, and for another company to recognize his or her talent, then their replacement can be found just as easily,” he says. “Since their skills and knowledge are so easily transferable, the threat that they can easily be hired by another company is proof that there is no special knowledge in what they do and that the fear of their leaving is groundless.”

The two investors interviewed for this report, Robert Talbut, formerly Chief Investment Officer of Royal London Asset Management and Chairman of the Markets and Asset Management Committee at the Investment Association, and Abigail Herron, Head of Responsible Investment Engagement at Aviva Investors, both argue that while a solid and efficient CEO will suffice in most situations, some circumstances do require a rarer breed.

For Mr. Talbut, that situation is most likely to arise when a company is faring particularly poorly, and needs a fresh direction. “There are more people around who could be good

CEOs than is commonly claimed," he says. "But when there is a real problem, you need an incredibly talented individual, with the knowledge, expertise and energy to turn that company around."

Mrs Herron agrees, but adds that certain industries also call for the rarer breed of CEO. "The scarcity of the skill set necessary to do the job determines how easily he or she can be replaced," she says. "Banking is one industry which does need rarer skills, because it is very technical, fragmented and subject to very close scrutiny from regulators".

Once again showing the subjective nature of this whole debate, another interviewee agrees that CEOs are harder to replace in certain industries, but cites different industries as examples. "In some high-tech and engineering businesses, you need a deep knowledge of the customer base and technology, built up over many years, to be really effective," says Mike Bourne, Professor of Business Performance at Cranfield University School of Management. "This is the exception, not the rule. Usually, CEOs can be relatively easily replaced."

Professor Bourne also takes issue with the notion that the skills of the turnaround CEO are rare, saying that the ability to "take a very cold look at a company, act decisively and make big changes is probably more prevalent than people think."

On this theme, we asked interviewees to specify the characteristics they thought were most crucial in any CEO. Opinions varied widely. For Sir Philip Hampton, it was hard work and "a thick skin". For Simon Wolfson, it was the willingness to take on responsibility. For Ed Smith, it was "a non-quantifiable gift for judgement". Sir Mike Darrington, former Managing Director of Greggs, argues that CEOs "need to have drive and enthusiasm, and a long-term strategic vision."

table 1 **Which of the following attributes do you value in a CEO?**

Total	**1089**
Intelligence	60%
Decisiveness	60%
Team work	56%
Hard work	35%
Negotiating skills	28%
Rigour	22%
Political skills	15%
International experience	9%
Luck	6%
Previous success as a CEO in another company	5%
Previous success in a senior role at your company	4%

The Institute of Directors survey, conducted on behalf of The High Pay Centre, asked a similar question. “Decisiveness” (with 60% of those surveyed selecting this option), “intelligence” (also 60%) and “team work” (56%) were the three most popular responses of the eleven presented (respondents could select as many as they wished) (table 1).

Not only do different respondents specify different characteristics, but the question of whether any particular individual possesses any stated characteristic is clearly in itself a matter of judgement. Some, for example, may interpret a person’s actions as decisive, whereas others may view the same actions as stubborn or rash. Most CEOs purport to have a long-term strategy – some may view that strategy as sound, others will see it as flawed. One and the same individual may fit well into certain teams, but clash with others.

Even if we can reach agreement about the importance of certain characteristics, or about whether a particular individual possesses these characteristics, it would be difficult to claim that the characteristics themselves are as rare as they are commendable. For example, can we really say “intelligence” is rare in the UK when 49% of young people enrol at university?[5] Can we say the capacity to work hard is rare when UK full-time employees work among the longest hours in Europe?[6]

Luke Johnson is in doubt that these highly-valued traits are more common than some might suggest. “It is not true that these skills – motivating people, delegating, strategic judgement, decision-making, talent spotting – are rare,” he says. “I just don’t believe it. I think there are lots of people out there who are hardworking, clever, motivated, ambitious, incisive and intelligent. I don’t accept that only a very few individuals can or want to run these businesses.” ■

[5] Department for Business Innovation and Skills, “Participation rates in higher education: Academic years 2006/7 – 2011/12 (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/306138/13-p140-HEIPR_PUBLICATION_2011-12_2_.pdf)
[6] Office for National Statistics, “Hours Worked in the Labour Market, 2011”, (http://www.ons.gov.uk/ons/dcp171776_247259.pdf)

Section 3: Subjectivity and opportunity

Due to the absence of any clear and objective measurement of executive performance, and the impossibility of proving nebulous assertions about the rarity and irreplaceability of their skills, the evaluation of the value of individual executives in large companies becomes very much a matter of conjecture. And the opinion that ultimately counts is that of the remuneration committees and their advisers who are making this evaluation. Given the huge rise in rewards over recent decades, the assumption that top executives exert a very substantial influence on company performance, and that they are extremely difficult to replace, clearly holds sway where it matters.

Phil Rosenzweig puts this down to a "mental shortcut", the human need to find simple explanations, often centring on the most prominent person in the story. Similarly, he says, excessive blame is laid at the door of a country's political leader during periods of economic downturn. But other interviewees suggest that career or financial motives are at least partly responsible for what they claim to be the disproportionate focus on executive influence and indispensability.

"Self-interest is deeply ingrained within the system," says David Henderson. "Non-executives of one company are directors at other companies. Unless working on a fixed fee basis, headhunters' fees tend to be calculated as a percentage of the executive's first year remuneration, which acts as an incentive for the remuneration to be as high as possible. Fund managers are rewarded like bankers and big company bosses, and this inevitably affects how they judge individual performance." The subjective nature of performance measurement, in other words, opens up great opportunities for well-positioned individuals to formulate the intellectual justification for taking a healthy slice of the huge revenues flowing through large corporations.

While espousing a very similar line to Mr. Henderson, Luke Johnson also lays specific blame at the door of the principal-agent problem, the disconnect between corporate managers and their entourage on the one hand, and the ultimate shareholders (the millions of individuals who invest their savings in companies through institutional shareholders) on the other. "What we are seeing is an unconscious exploitation of the system of dispersed ownership, with those inside the system able to capture it for themselves in the absence of any organised opposition," he says.

The vested interests elevating the influence and rarity of senior executives are labelled by Anthony Hilton as "a complex monopoly" and a "tacit conspiracy", which "is using its power to extort the system and rip off the ultimate shareholders".

It has not always been thus. The "dispersed ownership" which Mr. Johnson discusses is a relatively recent phenomenon, reflecting the great increase in occupational pensions and individual savings since the 1960s. According to his logic, the cult of the CEO has only had the opportunity to flourish in the years since then. Ed Smith correctly points out that “at other moments in the history of business, the pie has been cut up differently.” Moshe Adler of Columbia University quotes the early nineteenth century economist, David Ricardo, who observed that all production is carried out by teams, where the contribution made by each worker (or machine) cannot be separated from the contribution of the rest. Therefore, Ricardo explained, the way in which the fruits of labour are divided cannot be determined by productivity; it is actually determined by “the habits and customs” of the day.

Section 4: The value of long-term assessment

Several interviewees said that the more long-term the judgement of either corporate or individual executive performance, the more likely that the element of luck will be minimised. In other words, any fool may be able to preside over success in a year-long period if market and economic conditions are ideal. But lengthen that period to ten years, with several business cycles occurring within that time frame, and it then becomes more probable that only the genuinely top performers will shine through.

“Various external and economic factors can distort a short-term share price”, says Simon Wolfson of Next. “Only a long-term view will give you an accurate measure of company performance.”

Abigail Herron of Aviva Investors believes that only by following such a long-term perspective can investors overcome often superficial or misleading first impressions. “Naturally, some CEOs can be very charming, but at some stage they have to align the talk with something concrete,” she says. “In the long term, they have to deliver.”

Excessive focus on short-term performance, on the other hand, can hide fundamental problems that don’t get picked up in that time frame. ““If someone is in post for a very short time, their performance can look very good because they make the financials look better, but they can leave a disaster behind that doesn’t get picked up for another 12 or 18 months,” says Mike Bourne of Cranfield School of Management.

Tim Martin of Wetherspoon takes the argument one step further, maintaining that short-term measurement criteria may not only be deceptive, but can also be harmful to the company, with self-interested executives pursuing counterproductive strategies for personal gain. A five-year perspective will lead CEOs to reduce costs, for example, in order to increase both earnings per share over that period and the resulting executive remuneration, even though this may have an adverse effect on the company itself,” he explains. “The entire structure of corporate pay is based on performance over one, three or five years, when 10, 15 and 20 is more important.”

The points raised by Professor Bourne and Mr. Martin may be similar, but the specific time horizons they cite reveal another potential grey area. The former instinctively talks of hidden problems being exposed within “12 to 18 months”, whereas the latter alludes to much longer time spans. Robert Talbut, meanwhile, hints at an intermediate period, saying “that we cannot form a judgement on how well a company and its management are doing over three years.” And so we enter yet another area open to conjecture – what exactly constitutes “long- term”?

Just as with the question of CEO impact, several interviewees believe that the answer to this question depends on the industry in question. “Companies in the pharmaceutical sector, which depend on long-term investment on research and development, will have a much longer-term assessment period than retail, for example," says Abigail Herron. "There are no hard and fast rules for the length of time performance should be measured by," agrees Simon Wolfson. "Five years, for example, might be too short a time perspective for property companies, and too long for retail companies."

Any serious move to eradicate short-term evaluation of performance is likely to be met by similar resistance to that which follows any questioning of CEO impact or replaceability, and for similar reasons to boot. "People used to take a more long-term view because they couldn't make big bucks in a short period, but all that has changed," says Sir Mike Darrington.

table 2 **What is the correct time horizon of company performance for determining performance-related pay?**

	Total
Total	1089
1 year	11%
1-3 years	48%
3-5 years	31%
More than 5 years	5%
Other (please specify)	5%

Certainly, the Institute of Directors survey indicates that there is little appetite among executives for a long-term view. Around three in five respondents (59%) said that the "correct time horizon of company performance for determining performance-related pay" was not more than three years. Only 5% believed it should be longer than five years (table 2).

Associated vested interests may also benefit from short-term measurement criteria. "The ultimate owners – the man on the street with an insurance policy or pension – may be thinking more long-term about their investment, but the custodians of their investments – the institutional investors or fund managers – are thinking short-term because that is how their own incentives work," says David Henderson.

Others warn that even long-term term measurement may not necessarily act as an all-embracing panacea that serves to reward the deserving and reconcile the interests of executives and ultimate shareholders. "We can expect from the law of probabilities that some companies are going to do well over a number of years," says Phil Rosenzweig of IMD Business School. "If you flip coins ten times in a row, a certain number of people will have flipped heads ten times. Similarly, you would expect a certain number of companies in the S&P 500 to perform very well over a ten-year period."

Meanwhile, Anthony Hilton doubts that a long-term assessment will have the desired effect of making executives think further into the future. "Judging corporate performance over ten years will enable you to see how sustainable the strategy has been, whether it was merely tailored to the short term," he says. "But the problem is that any executive compensation resulting from that measurement is pointless, because evidence shows that people's behaviour is not affected by such long-term incentives." ■

Section 5: Non-financial performance measures

A large proportion of respondents to the Institute of Directors survey pointed to non-financial criteria as important factors in the assessment of company performance. Around three quarters (74%) stated that "customer satisfaction" is a "very important" factor, with more than half (53%) saying the same about "employee engagement" (table 3).

However, several interviewees expressed serious doubts about non-financial measures, arguing that they are difficult to pin down and that any incentives associated with them may conflict with broader business goals. "Beware of secondary measures of performance", warns Simon Wolfson. "They tend to be malleable and can lead to unintended consequences. For example, a CEO could invest hugely in an area of customer service for which he knows he will be rewarded, even though this action may be against the long-term financial interests of the company. Delivering long-term value to shareholders is the only measurement worth having."

Luke Johnson agrees, cautioning against any negation of the principal role of a company in a capitalist society. "If the raison d'être of a company is to make life comfortable for its employees, or to provide the best possible value to its customers, then it ceases to be a business," he says. ""For profit" means that the company is there to make a profit. Generally speaking, that profit motive has shown itself to be a very powerful catalyst for job and wealth creation."

Others claim that non-financial measures can be too easily manipulated by insiders, as those looking in from the outside cannot possibly grasp the detail involved in the day-to-day administration of the company. "Fund managers naturally gravitate towards financial measures like total shareholder return or

table 3 **How important are the following factors when assessing company performance? (Rank in 1-5 with 5 very important)**

Employee engagement	Profitability	Shareholder value	Jobs created	Investment	Customer satisfaction	Reducing environmental impact	Contribution to society	Reputation	Brand recognition
0%	0%	2%	5%	2%	0%	5%	4%	0%	1%
1%	1%	3%	10%	7%	0%	11%	10%	1%	3%
6%	2%	11%	45%	35%	2%	39%	35%	6%	17%
40%	31%	43%	32%	46%	23%	37%	42%	29%	44%
53%	66%	41%	7%	9%	74%	9%	9%	64%	35%

earnings per share because they understand them," says Anthony Hilton. "However, these have almost nothing to do with the routine challenges faced by the person actually running the business. The problem is that the non-financial metrics which do matter from an operational standpoint are understood much better by the CEO than by anyone else, so if they are used to gauge performance it is highly likely he knows how to game the system."

Mike Bourne believes that "the problem with non-financial metrics is that if you pay for KPIs (key performance indicators), you get improvement of KPIs," and reminds us that "the "I" stands for "indicator", not performance."

To illustrate the point, he cites an example he witnessed in the public sector. "All grant applications had to be reviewed by a particular team within a three-month period," he says. "The way it managed to achieve a 100% success rate was to reject high-quality applications that couldn't be completed within three months, and tell the relevant applicant to try again. As they had already reviewed these applications in part, they were efficient to review again. The team therefore concocted some impressive numbers, but the performance didn't actually improve."

This scepticism about non-financial performance measures was certainly not uniformly felt by all interviewees. Others argued that the emphasis on financial results was far too narrow, and that only including non-financial measures could redress this imbalance. "We have to look at performance in a wholly new light," says Sir Mike Darrington. "We need to have companies that are effective over the long term, growing and providing robust employment, meeting customers' needs, not only making profits but paying taxes and reinvesting properly so that the company can continue to prosper, employees feel appreciated and still have their jobs, and customers feel welcomed and continue to be served."

"Sustainability entails looking beyond short-term financial performance", agrees Daniel Godfrey, Chief Executive of the Investment Association. "Other factors which create that sustainability include new product pipelines, research and development, customer satisfaction and employee engagement." He thinks that we should not be fixated on finding the perfect measurement for these non-financial measures. "It is questionable whether you really need absolutely precise metrics," he says. "For example, there is a developed market for measuring employee engagement. They may not be exact, but the measures will certainly give you a sense of the direction of travel."

If one is persuaded of the need for non-financial metrics in measuring corporate or individual executive performance, the issue then becomes one of emphasis. How much of the performance measurement should focus on the financial, and how much the non-financial? Phil Rosenzweig believes that financial measures will always dominate, but that does not mean we should feel free to ignore everything else. “Performance is not just financial; there are many more stakeholders than just shareholders,” he says. “Is there a danger that CEOs will make decisions detrimental to the long-term health of the company if they pursue non-financial targets? It’s a question of degree. Non-financial metrics are always going to be relatively incidental in the overall incentive package. But it’s too narrow to send a message to CEOs that all we are interested in is financial performance.” ■

Conclusion: Two parallel conversations

It is unlikely that many remuneration committees spend much time discussing the issues raised in this report. Mired in the convoluted technical minutiae of how top executives should be paid, they lose sight of the basic questions which should determine whether it is rational to offer such high rewards in the first place, however they are distributed. For reasons of self-interest or inertia, fixed assumptions about the fundamental issues of executive impact and replaceability are so deeply embedded within the system that they are not exposed to proper scrutiny. The very real doubts expressed by the distinguished interviewees for this report in a private capacity will seldom see the light of day in those forums where they might have some practical effect.

If there is one thing that this report makes clear, it is that many of the prevailing convictions about individual executive performance are very far from incontestable. Much else, however, remains very unclear. We do not know how much impact the CEO or his team exert on corporate performance; we do not know how replaceable they are; we do not know what constitutes the most helpful definition of long-term; we do not know how reliable or useful non-financial measures of performance really are. We may have strong opinions, but we cannot prove them to be true.

But nor can others prove them to be false. In the absence of any organised opposition within the decision-making process to query the conventional corporate wisdom, the subjective nature of performance assessment has allowed many top executive employees of major corporates to become extremely wealthy in recent decades.

The problem is that a large number of ordinary people, who are not immersed or even interested in the arcane detail of long-term incentive packages, are indeed asking these fundamental and logical questions about the rationality of high executive pay, and are concluding that many rewards derive from being in the right place at the right time, rather than from the potent application of rare talent. As this report itself indicates, many high earners themselves believe the same thing. A 2011 Ipsos Mori research study, commissioned by the High Pay Centre, examined attitudes among the top 1% of UK earners, and found that "participants tended to think that their industries would be offering these salaries with or without them – there was a sense that the money was there for the taking."[7]

If the chasm between the corporate world and ultimate shareholders is not to grow yet wider, and faith in the system not to become dangerously fragile, companies will surely have to work far harder to convince people that high performance, not superficial perception or self-serving entitlement, is the driving force of high pay. ■

[7] The High Pay Commission, 2011. "Just deserts, or good luck? High Earners' attitudes to pay", (https://www.ipsos-mori.com/DownloadPublication/1447_ipsos-mori-hpc-high-earners-attitudes-to-pay.pdf)