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# PAID TO PERFORM?

WHAT DO WE WANT OUR BUSINESS  
LEADERS TO ACHIEVE?

## 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 is grateful to its supporters and would like to thank the Polden and Puckham foundation for funding this work.

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## Forward

*Profit without purpose is a recipe for disaster. As an industry - and indeed I would say as a global society - we have become wrapped in our own rhetoric. We need to learn how to be comfortable with articulating purpose and reject the idea that money is the only effective measure of all things or that the free market is the only sorting mechanism.<sup>1</sup>*

Elisabeth Murdoch was chiefly referring to the media in her Edinburgh speech, but her sentiments capture a key debate about our economic system. The round of soul-searching prompted by the financial crisis has seen an increasing number of people questioning the way our companies are run. A focus on short-term profits to the exclusion of other objectives is felt by many to have led British business and particularly our banks, on a roller-coaster ride - in some cases - towards destruction.

However, what are business leaders supposed to do? For years shareholders have been telling them that they must align themselves with the owners of the company. This has meant tying executive pay packages to returns for company shareholders.

The focus almost wholly on short-term measures of financial performance has incentivised many executives to go for broke. They stand to make a lot of money from prioritising profits and share price, usually measured by investors in quarterly increments. Chief executives' average pay packages have trebled in the past 10 years from £1.5million to £4.8million, but the FTSE 100 index of share prices is almost back where it started the decade.<sup>2</sup>

There is now a growing movement among shareholders, economists and critics of the current system to look for more sustainable ways of running companies.

*“Financial incentives have only a limited role to play in the creation of successful businesses,”*

says the Local Authority Pension Fund Forum in a recent report.<sup>3</sup> An influential shareholder body, the Local Authority Pension Fund is looking at how a company's focus can be shifted to take more account of its employees and customers.

If chief executives are to create more sustainable businesses, their incentives need to change. While the High Pay Centre is sceptical about the effectiveness of performance-related pay in general, if it is to remain part of the corporate landscape, it should be made to work better. Executives' pay should be determined by more than just short-term financial outcomes. This report is an attempt to look at existing measures of company performance, at why they are not the full answer to long-term viability and what can be done instead.

If executives see that their own financial future is more closely tied to running companies sustainably, their behaviour could be a lot different.

Leading shareholders in the Association of British Insurers have recently called on companies to consider ways of rewarding directors that are not just based on measures of financial performance.<sup>4</sup> The debate needs to go further. Executives should be given incentives to look at other factors creating success. This would not just benefit those executives, but their employees, customers and indeed, wider society as a whole.

**Deborah Hargreaves, founding director of the High Pay Centre**

## Executive summary

Britain's business leaders have been criticised for taking a short-term approach to the companies they run and failing to develop a strategy for a long-term sustainable future. The financial crisis has put a focus on the issue of short-termism. But chief executives are given incentives to chase short-term profits because their pay is overwhelmingly linked to financial measures of company performance such as earnings per share (EPS) and total shareholder return (TSR).

### Existing performance measures

Our analysis of the annual reports of the FTSE 100<sup>5</sup> companies found that CEO performance is mainly measured against financial outcomes.

- Total Shareholder Return (TSR) was the most popular measure, used to calculate at least one element of performance-related pay by 74 out of 100 companies.
- 96 companies used either EPS or TSR or a combination of both, to determine performance for their chief executive's Long-Term Incentive Plan (LTIP).
- Only seven companies used non-financial measures for calculating their LTIP. In each case, non-financial factors accounted for less than 50% of the pay awarded.

However, financial performance measures can be misleading and fail to capture fully the way the company is operating.

### Broader performance measures

The broader factors that affect company performance include:

- Employees - Motivating, developing and retaining several thousand staff, and engaging them in a common purpose is one of the most challenging tasks for a company executive and is critical to the company's long-term success.
- Customer satisfaction - Companies with a reputation for poor quality or poor service are unlikely to thrive in the long-term
- Trust/reputation - Brands such as BP, News International and a number of banks have been tarnished by reputational issues.
- Innovation and productivity - crude financial performance measures fail to differentiate between companies that increase share price and profitability by building brands and developing their product, and those that do so by cutting costs.

### Shareholder value

Shareholders have called for chief executives' pay to be linked to company performance in order to better align the interests of managers with the owners of the company.

The focus on short-term financial measures can encourage executives to increase the share price and profits by cutting costs and investment, or by speculative mergers and acquisitions and share buybacks. However, this can have adverse long-term consequences for companies. For example, BP

<sup>1</sup> Elisabeth Murdoch, chairman and CEO of Shine, in the James MacTaggart memorial lecture, Edinburgh 23 Aug 2012

<sup>2</sup> Figures from Manifest/ MM&K

<sup>3</sup> Local Authority Pension Fund Forum report: People and Investment Value, 29 Nov 2012

<sup>4</sup> <http://www.guardian.co.uk/business/2012/nov/26/curb-executive-pay-advise-insurers?>

<sup>5</sup> Companies in the FTSE 100 stock market index in November 2012

attempted to cut costs on its US drilling rigs, but ended up with a \$100 billion bill in the aftermath of the Deepwater Horizon disaster. ICI and GEC prioritised speculative acquisitions over the development of their core business in the late 1990s and now no longer exist.

The average length of shareholding in the UK is seven months, while the timeframe over which chief executives' so-called 'Long-Term' Incentive Plans are measured is usually three years. It can take much longer than this to build a successful brand, develop a compelling new product or significantly increase the skills and capacity base of a company workforce.

### **Social and environmental performance**

Similarly, narrow financial performance measures do not gauge the wider impact that companies have on society as a whole. Big companies have a profound effect on the individual wellbeing of their employees and customers who depend on them for their income and development opportunities, or vital products such as food, fuel and transport.

On a broader level, companies have a critical role to play in society through their investment in staff training, research and development and their contribution to tax revenues. Business also benefits from government investment in infrastructure and public services. There are therefore both practical and moral reasons why company

performance measures should reflect the interests of society as a whole.

### **Recommendations:**

In order to promote a broader definition of company performance and encourage chief executives to run their companies on a more sustainable basis, we make the following recommendations:

#### **1 Non-financial performance measures should constitute at least 50% of performance-related executive pay**

- measures such as employee engagement; customer satisfaction; and social/environmental performance are critical to understanding a company's long-term success and its net impact on society.

#### **2 Reporting on social and environmental performance should be mandatory**

- this should include specific indicators such as tax paid in the UK; employee turnover; company pay differential; or emissions levels. This data could be used to calculate performance-related pay.

#### **3 Government should use tax and procurement incentives to encourage companies to focus on wider measures of performance**

- Preferential tax rates would promote compliance with environmental and social reporting requirements. The Social Value Act could also be used to ensure that compliant companies were favoured in Government procurement decisions

#### **4 Pension fund trustees, investment managers and**

#### **commercial pension providers should be required to take into account the social/environmental impact of their investments on beneficiaries.**

A revised fiduciary duty should recognise that the interests of pension fund beneficiaries are bound with those of society as a whole.

#### **5 Employee representatives should be elected to company boards**

- Employees on boards would advocate a much broader definition of company success, and challenge decisions based on short-term financial considerations that may jeopardise the company in the long-term.

Together, these policies would represent a genuine shift away from the approach to business that caused the financial crisis. They would ensure that company performance is judged in terms of a company's value to society as a whole, rather than to a narrow constituency of shareholders. •

## Introduction

*'Short-termism in business may be characterised both as a tendency to under-investment, whether in physical assets or in intangibles such as product development, employee skills and reputation with customers, and as hyperactive behaviour by executives whose corporate strategy focuses on restructuring, financial re-engineering or mergers and acquisitions at the expense of developing the fundamental operational capabilities of the business.'*<sup>6</sup>

Business in Britain has been criticised for its short-term approach. Policymakers and economists have questioned why British business leaders struggle to build long-term, sustainable companies. However, this should come as no surprise to anyone who has read a company remuneration report. Most top executives are incentivised to make short-term financial rewards for their shareholders since this is how they achieve their own maximum earning potential.

The most widely-used measures for calculating performance-related executive pay are connected to company share price, or profitability. This is measured over a period of up to three (or very occasionally five) years and is a comparatively short-term and narrow view of company performance. A number of leading commentators have suggested that the use of these measures and incentives are damaging to UK businesses and contributed towards the recent financial crisis. For example, the Kay review of Equity Markets concludes that:

The Bank of England's Andrew Haldane echoes this refrain:

*'The short-termism problem is especially acute in the financial sector, where job tenures and performance targets have tended to be short, especially for CEOs. Pre-crisis, this encouraged unhealthy rent-seeking and risk-taking, gambling on one more, big bonus. This gave rise to all the wrong incentives if the aim was to generate long-run value for customers and investors.'*<sup>8</sup>

In addition to promoting short-termism, and encouraging risky speculation at the expense of genuine improvements to innovation and productivity, narrow financial performance measures also ignore the wider impact of companies on their employees, customers, surrounding communities and society as a whole. It is important to understand what company executives are currently paid to deliver, and the consequences of this for wider society. This paper analyses the current system, looks at why it encourages short-term behaviour on the part of leading executives and recommends a series of policy changes that would prompt them to behave in a longer-term, more sustainable way.

<sup>6</sup> John Kay, the Kay Review of UK Equity Markets and long-term decision-making, Department for Business Innovation and Skills, 2012, p10

<sup>7</sup> Kay Review, p63

<sup>8</sup> Andrew Haldane, A Leaf being turned, Executive Director, Financial Stability, and member of the Financial Policy Committee, Bank of England; speech to 'Occupy Economics' October 29 2012

*'We believe the lesson of recent financial crises is that the cultural changes we seek can be achieved only by changing the structure of the industry and the incentives of those who work in it.'*<sup>7</sup>

## Turning a fast buck: current measures of executive performance

Our analysis of the annual reports of the FTSE 100 companies<sup>9</sup>, found that CEOs are overwhelmingly measured against their companies' financial performance.

- Every CEO pay package was predominantly calculated using financial performance measures, based on the company value and profit as recorded in their financial statements, or in terms of their share price and payment for shareholders.
- Total Shareholder Return (TSR)<sup>10</sup> was the most popular measure, used by 74 companies to calculate at least some part of their CEO's pay.
- Earnings-per-Share (EPS)<sup>11</sup> was the second most popular, used by 64 companies.
- A majority of companies used TSR and EPS when calculating Long Term Incentive Plans (LTIPs) which usually pay out after three years. LTIPs often form the largest proportion of an executive pay package, with a value of up to 700% of a CEO's basic salary.<sup>12</sup>
- 96 companies aligned their LTIP, at least in part, with either TSR and/or EPS. 37 companies used only TSR and/or EPS to calculate their LTIP
- Other financial measures used, at least in part, by a significant number of companies included
  - Cashflow,
  - variations on profit or earnings,
  - variations on return on capital, or return on equity,
  - financial measures relating to a specific business priority, such as market share or growth in sales for particular markets or products.
- The measures used largely relate to the figures recorded on corporate financial statements, rather than how these figures were achieved,
- 24 companies did not mention

non-financial performance at all in their remuneration report. A further 38 referred to unspecific 'personal objectives' or 'non-financial performance' with no reference to quantifiable ways in which these could be measured,

- Only 38 companies committed to assessing CEO performance in ways that could measure non-financial factors. Common metrics included:
  - Health and Safety record
  - Environmental impact
  - Customer satisfaction
  - Employee Engagement
- These are sometimes included alongside other non-financial measures under broad headings such as 'strategic objectives.' The precise weighting of the non-financial element, and therefore the incentive for the executive to deliver non-financial objectives, is, in many cases, uncertain.
- The non-financial performance measures are generally used to calculate annual bonuses. The non-financial element usually relates to less than half the total bonus award. Annual bonuses account for up to 200% of a CEO's salary.<sup>13</sup> This is a much smaller proportion of performance-related pay than that covered by LTIPs.
- Only 7 companies mentioned non-financial performance measures in their LTIP – in each case the non-financial measures accounted for a much smaller element of the LTIP than that linked to EPS, TSR or other financial metrics.
- The companies with the largest proportion of non-financial measures linked to the CEO's LTIP were those that had undergone recent reputational damage such as BP, Barclays and HSBC.

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<sup>9</sup> FTSE 100 companies in Nov 2012. Most companies use more than one performance measure

<sup>10</sup> TSR is the increase in the value of the share price plus dividends

<sup>11</sup> EPS is the profit per outstanding share

<sup>12</sup> High Pay Centre, It's how you pay it: Making sense of the complicated world of executive pay, High Pay Centre, 2011

<sup>13</sup> ibid

## Not all they seem: financial yardsticks can be misleading

Our research clearly demonstrates that non-financial performance measures form only a minor proportion of the performance-related pay packages awarded to FTSE 100 CEOs. Executives are far more heavily incentivised to prioritise performance as measured by financial success, primarily TSR and EPS.

The culture of Britain's large companies is currently geared towards delivering the increase in share price, dividend payments and profits used

to calculate EPS, TSR and many of the other financial metrics also aligned with executive pay packages. Furthermore, they are focused on doing so over a relatively short time period of, at most, the three years over which 'Long-Term' Incentive Plans measure performance, and some annual bonuses are deferred. •

Financial Performance measures are well-established as a conventional means of judging company performance. Measuring a company's finances would appear to be a reliable way of assessing its success, and shareholders are understandably keen to know how much money a company is making for them. However, there are problems with financial measures because they can be less objective than they appear. It is also difficult to discern whether the measures employed are an accurate gauge of a company's overall performance.

Financial performance measures are either accountancy-based or market-based. Accountancy-based measures are calculated by using the company's accounts – common examples used by FTSE 100 companies include variations on EPS (earnings per share) or ROCE (return on capital employed) which are based on the profits recorded in the accounts and/or assets and liabilities. Market-based measures, such as Total Shareholder Return (TSR), relate to the company's price on the stock market. Elements of both mechanisms can be highly subjective.

### Accountancy-based financial measures

Andrew Likierman of London Business School notes that company accounts are 'inevitably based on a series of assumptions about the future.'<sup>14</sup> Likierman highlights the depreciation of assets, the cost of pension liabilities and debt repayments as three major uncertainties inherent to accountancy-based measurements.

*'depreciation of fixed assets depends on an assumption of how long the asset will last and on its residual value. In the case of pension liabilities, the assumptions on liabilities for final salary schemes depend on the assumptions which include returns from investments and the longevity of pensioners, both over many years. For lending institutions, provisions for bad debts depend on the accuracy of models of future behaviour of borrowers. Accounts therefore provide precise indicators of performance only in as much as they apply precise rules to a set of uncertain events.'*<sup>15</sup>

So if a company has misjudged the value of its assets, for example, or the ability of its debtors to maintain repayments, their profits may prove illusory. Box 1 provides an example of why the inherent uncertainties contained in company financial statements limit their value as a guide to company performance.

<sup>14</sup> Andrew Likierman, Measuring Company Success - Paper presented at Performance Measurement Association Conference, London Business School, April 2006  
<sup>15</sup> *ibid*

**Box 1: Banking off-balance sheet**

The recent banking crisis provides a famous example of how accountancy-based performance measures can be misleading. A number of major banks became heavily exposed to sub-prime mortgages in the USA, with their loans recorded off-balance sheet through part-independent subsidiaries, or Structured Investment Vehicles, in order to avoid regulations on capital reserves. When sub-prime mortgage customers defaulted in higher numbers than expected, some banks were unable to meet their own debt obligations and were ultimately dependent on a government bail-out for their survival.

As the massive write-downs undertaken by the crisis-hit banks demonstrated, the assets recorded by banks had been grossly overstated, meaning that so were their profits. Though their exposure might have been more obvious were it not for the Structured Investment Vehicles, the fact that the banks, with full knowledge of their financial position as documented in their accounts, were willing to issue the loans at all, demonstrates that judgements made on the basis of corporate financial statements can be catastrophically flawed. This includes assessments of executive performance using measures based on data contained within these financial statements. Prior to the crash, neither the EPS nor the ROCE of the worst afflicted banks would have reflected their vulnerability.

**Market-based financial measures**

The share-price movements which dictate market-based performance measures such as TSR, can also be an unreliable indicator of company performance.

Market movements at least represent a view from outside the company – the value of a company as judged by external investors, as opposed to company

financial statements, which are both subjective, and based on figures prepared internally by company directors. However, they are still potentially misleading.

Firstly, share prices reflect market expectations. This relates to what will happen in future, and so is of little value as a gauge of past performance. Box 2 provides an example of how hype and expectations can override performance as a determinant- of share price.<sup>16</sup>

Secondly, market judgements are sometimes wrong. As with accountancy-based measures, the 2007 banking crisis provides a salutary lesson of how inaccurate they can be. The markets completely failed to recognise the inherently unstable business models established by leading banks. Former Chairman of City Regulator, the Financial Services Authority, Lord Adair Turner notes that

*‘the markets collective view was that risks to bank creditworthiness had fallen steadily between 2002 and 2007, reaching a historic low in the early summer of 2007, the very eve of the worst financial crisis in 70 years.... Bank equity prices provided no forewarning of impending disaster.’<sup>17</sup>*

John Maynard Keynes famously highlighted the psychology of markets as a potential risk factor in causing market failure. Participants attempt to identify not what constitutes the best

**Box 2: Apple and Blackberry**

Writing in October 2012, US academic Aswath Damodaran compared the increase in value of Research in Motion (makers of the Blackberry phone) to the decline of Apple. Damodaran notes that the Apple share price tumbled because of a small glitch in the map application on the iPhone 5. But because Apple has been so constantly successful for such a long period of time, this was taken as a sign by the market that the company was not infallible, and could make a bigger mistake in future.

By contrast, RIM had been subject to ‘unremittingly negative’ news stories, and therefore the revelation that the company’s quarterly losses amounted to ‘only’ \$235 million was seen as positive. It was not enough to wipe them out completely, so the company might have a chance to rebound, making it a potential bargain in the eyes of some investors looking to purchase stock at the bottom of the market.

In both instances, the fluctuations in the market value of the company was almost the complete opposite of a reward for excellent past performance.

value investment by their own objective judgement, but what the average opinion of best value will be. Replicated en masse, these attempts to second guess consensus create what Turner calls a herd mentality, and John Kay refers to as ‘the lemming standard.’<sup>18</sup> In their efforts to replicate what each other is doing, investors create rapid investment trends, often followed by a subsequent collapse when the initial judgement proves incorrect.

It is clear that the prevailing financial measures used to evaluate business performance and determine executive pay can be an unreliable guide to a company’s success. In order to better understand the weaknesses of these measures, it is vital to identify the critical factors shaping performance that are not necessarily captured by company accounts or market judgements. •

<sup>16</sup> Aswath Damodaran, Winning (losing) by losing (winning): The power of expectations via <http://aswathdamodaran.blogspot.co.uk/2012/10/winning-losing-by-losing-winning-power.html>, 9 October 2012, accessed 17 October 2012

<sup>17</sup> Adair Turner, Economics after the Crisis: Objectives and Means, MIT Press, 2012, p53

<sup>18</sup> Economics after the Crisis p43 and Kay Review of UK Equity Markets p63

## It's not just about money: workers are important too

As has been shown, the financial performance measures most prevalently used amongst large companies can be dictated by factors beyond the companies' control, and often fail to gauge performance correctly.

Financial performance measures are simplistic, and do not explain how profits were achieved – on a yearly-basis, or even over the three year periods covered by 'long-term' incentive plans. Profit and share price increases can be driven by cost-cutting or speculation as much as genuine improvements to products and services.

In order to understand whether a business leader has implemented a long-term, sustainable strategy for success, it is important to examine critical underlying factors such as human capital and employee engagement; customer satisfaction; trust and reputation; Corporate Social Responsibility; or levels of research, development and innovation

### Human Capital

The academic evidence demonstrating the benefits to businesses of improved employee engagement is striking. The final report of the High Pay Commission cites multiple studies confirming that highly engaged employees generate substantial cost savings for businesses in terms of reduced staff turnover, sickness absence and accidents at work, while also increasing revenue through heightened productivity and greater commitment to corporate goals leading to improved customer advocacy.<sup>19</sup>

The sheer logistical challenge of managing tens of thousands of employees, channelling their productivity appropriately, and forging a coherent corporate identity that binds them to the company is one of the foremost challenges for any business leader. Their success or otherwise in this respect is clearly crucial to the company's long-term prospects.

### Customer satisfaction

Equally, customer satisfaction is clearly a vital measure of company success – it is hugely important in determining whether revenues have been generated in a sustainable way. Companies with a reputation for poor quality/poor service are unlikely to thrive in the long-term, particularly in an interconnected age when it is becoming increasingly easy for poor consumer experience to be disseminated via the internet.

Research for Oracle in the USA found that:

- > 89% of consumers had switched to a competitor after experiencing poor customer service;
- > 86% said they would pay more for an improved customer experience;
- > 26% have posted negative comments about a company on a social networking site after experiencing poor customer service.<sup>20</sup>

A number of companies have undergone significant reputational damage after comparatively minor complaints went viral via email and/or social media. As internet-usage increases in developing economies and generations who have grown up

with social media become a larger part of the market, there will be a corresponding growth in the power of consumer activism. A business that has pro-actively improved performance in this respect is clearly more resilient to a changing social/technological environment, but this is not necessarily reflected by existing measures of performance.

### Trust and Responsibility

Customer service is also linked to wider issues of trust and reputation. Again, these are clearly vital to business' long-term interests. The News of the World is a prominent example of a business damaged irreparably by reputational issues. A number of other companies have undergone similar scandals – the banking sector more or less in its entirety; BP over the Deepwater Horizon disaster; businesses such as Vodafone and Starbucks, relating to tax avoidance; Primark, part of the Associated British Foods Group, because of the use of child labour in its supply chain; and the 'big six' energy companies which have seen their businesses heavily criticised over sharply rising energy prices.

The Edelman Trust Barometer notes that just 38% of UK citizens 'trust business to do what is right.'<sup>21</sup> This is the fifth lowest of the 25 countries surveyed.<sup>22</sup> Only 30% judge CEOs to be credible figures.<sup>23</sup>

Though trust and reputation can take a long time to build, they can be lost much more quickly, making it vitally important that executives are incentivised to

safeguard and strengthen social and environmental performance, and other areas that affect trust in the business. BP for example, had built its branding campaign around the 'Beyond Petroleum' slogan and green credentials for many years, but in the aftermath of the Gulf of Mexico oil spill it is doubtful that environmental leadership is something that consumers readily associate with BP.

There are a number of obvious ways in which low levels of trust could have an impact on businesses: for example, loss of customers, or a lack of willingness from other key stakeholders (eg suppliers, distributors or advertisers) to engage with the company.

It is also likely that a company with a poor public reputation would be less desirable to work for. The Sky Future Leaders Survey, involving graduate trainees, high-potential middle managers and MBA students, found that

- > 79% of survey respondents cite the vision and values of a company as an important factor when looking at a potential employer;
- > The top 5 factors for judging quality of business were: 1) quality of product 2) customer service 3) values and ethics 4) reputation as good employer 5) financial track record;
- > 34% see 'creating social and environmental value through business' as a key career goal versus 35% for 'quickly increasing salary or bonus.'<sup>24</sup>

It is often argued that a failure to pay executives the astronomical salaries that have become commonplace

<sup>19</sup> High Pay Commission, Cheques with Balances: why tackling high pay is in the national interest, 2011, p29

<sup>20</sup> Oracle, 2011 Customer Experience Impact Report: Getting to the Heart of the Consumer and Brand Relationship, 2012 via <http://www.oracle.com/us/products/applications/cust-exp-impact-report-epss-1560493.pdf> accessed 18 October 2012

<sup>21</sup> Edelman Trust, Edelman Trust Barometer 2012, via <http://edelmaneditors.com/2012/01/trust-barometer-2012/> accessed 18 October 2012

<sup>22</sup> ibid

<sup>23</sup> ibid

<sup>24</sup> Sky, The Sustainable Generation: Sky Future Leaders Survey, 2011, p6-7



<sup>25</sup> Financial Times, It's plain for all to see, ESG research works, October 21 2012 via <http://www.ft.com/cms/s/0/b22c49c8-06e8-11e2-92ef-00144feabdc0.html#axzz2Cn0oCUhU> accessed October 25 2012

<sup>26</sup> Rosabeth Moss Kanter, How Great Companies think differently in Harvard Business Review, 1 November 2011,

<sup>27</sup> ibid  
<sup>28</sup> ibid

<sup>29</sup> Ha Joon Chang, 23 Things they don't tell you about Capitalism, Allen Lane, London, 2010, p19

*'academic research consistently finds a lower cost of debt and equity capital for companies with better Environmental and Social Governance (ESG) performance characteristics. Nearly 90 per cent of studies find that companies with high ESG ratings outperform both operationally and in market terms.'* <sup>25</sup>

will lead to a failure to attract and retain talent. This evidence suggests that the ability to demonstrate strong social values and an ethical business model will be at least as important in future.

In the long-term, the benefits of a responsible business that builds higher levels of trust could pay off financially. A review for Deutsche Bank in June 2012 estimated that:

Writing in the Harvard Business Review, Rosabeth Moss Kanter argues that firms should conceive of themselves as 'enduring social institutions', with the interests of wider society given at least an equal weighting to economic or financial considerations in strategic decision-making.

*'the value that a company creates should be measured not just in terms of short-term profits or paychecks but also in terms of how it sustains the conditions that allow it to flourish over time.'* <sup>26</sup>

Kanter argues that, in addition to the value added through stakeholder engagement, improved Corporate Social Performance also creates greater resilience and enhances the prospect of growth in an increasingly globalised economy.<sup>27</sup> As emerging markets develop, and the volume of business done by Western companies in unfamiliar countries with different

economic and cultural traditions increases, a clear social mission can facilitate the vital relationships with local regulators and opinion leaders necessary to secure a real competitive advantage.<sup>28</sup>

Both in the developed world and in emerging economies, poor social performance by an individual company can shape attitudes towards entire industries and the very concept of business. For example, the Bhopal disaster in India in 1984 resulting from Union Carbide's negligent safety procedures continues to affect relationships between the US and India to this day, while potential regulation of the UK media business in response to the illegal activities of News International employees could change the sector profoundly. Despite this, very few companies link their chief executive's pay package to responsible business practices. Those that have done so are generally companies that have already suffered a major corporate crisis, such as BP and HSBC, suggesting that businesses see non-financial incentives as a way of safeguarding against damaging executive behaviour.

### Innovation

Businesses can improve financial performance by growing revenue or by cutting expenditure. Leading economist Ha Joon Chang observes that it is far easier to achieve the latter through cost-cutting measures, than the former through innovation and product development.<sup>29</sup> Fellow economist Mariana Mazzucato describes this

as the difference between 'value creation' and 'value extraction.'<sup>30</sup> But the financial performance measures currently used by UK companies make no allowance for how profitability or share price increases are achieved.

While cost-cutting is sometimes justified, profits arising from a brilliant product innovation or brand development are more likely to be sustained in the long-term.

Savings achieved by sacking a substantial proportion of the workforce, for example, leave those that remain working more intensively with reduced levels of morale and attachment to the company, and a higher risk of accidents. Extending the life-cycle of dated equipment again increases the risk of accidents, production failure or the loss of competitive advantage to rival companies with more sophisticated technology.

So revenue growth is clearly a preferable way for companies to improve profitability, but crude accountancy-based performance measures such as EPS or ROCE fail to differentiate between the two.

Equally, share price can be manipulated by stock buybacks, whereby the company invests its own profits in shares, in order to drive their market value upwards. This then increases a company's TSR (total shareholder return), so again, an executive could be rewarded just as handsomely for sacking hundreds of his employees and investing the savings in company stock, as for developing an innovative new product that sells millions.

Clearly, performance measures that distinguish between 'value creation' and 'value extraction' are needed to remedy this. •

<sup>30</sup> Mariana Mazzucato, Re-Balancing What? Reforming finance for creative destruction not destructive creation, Policy Network, 2012, p4

## In it for the long-haul? How existing gauges of performance discourage long-term thinking

It is possible to argue, that if research and innovation – or employee engagement; social responsibility; customer satisfaction; or trust – are so important to a company’s long-term sustainable future, then this will eventually be reflected in its financial performance. Therefore, replacing/complementing existing performance criteria with non-financial measures would be pointless. CEOs are already incentivised to embed these non-financial indicators in business strategies by financial performance measures. In theory, this would lead to improved financial performance and the CEO will be rewarded.

In practice, however, the timeframe of CEO pay packages means that a focus on sustainable, long-term growth may go unrewarded. Annual bonuses still account for a significant proportion of many executives’ pay packages, so short-term revenue generation is still a plausible and relatively easy way for executives to fulfil their performance criteria.

Even so-called ‘long-term’ investment plans are generally only three years in length. It is entirely possible that the superior long-term performance generated through measures such as the development of new products; more extensive provision of staff training; or heightened levels of public trust and customer satisfaction resulting from a renewed focus on social responsibility would take longer to be realised. Public perceptions of the brand, or the skillset of the workforce are crucial (if intangible)

assets to companies. But these assets are built up over many years, and are not something even the most gifted CEO can deliver to a fixed, short-term timeframe.

### Shareholder value and short-termism

It is unlikely that businesses can be persuaded to measure performance on a more sustainable, long-term basis without challenging the focus on shareholders and asking in whose interests a company is run. It is well –documented that most UK businesses see their primary objective as being to maximise the returns they generate for shareholders. This explains the particular incentives currently used in most executive pay packages, and is explicitly noted in the remuneration reports of the FTSE 100 companies:

*‘It is important to ensure that levels of reward are commensurate with performance and that the Company’s reward policy creates a strong alignment between its shareholders and executives.’<sup>31</sup>*

Anglo American

*‘For executive Directors, remuneration is heavily geared to the achievement of challenging objectives and targets that directly align executive and shareholder interests.’<sup>32</sup>*

British Sky Broadcasting

*‘Remuneration strategy... to achieve optimal alignment of the reward framework with the creation of shareholder value’<sup>33</sup>*

BAE Systems

However, the interests of shareholders in UK companies have become more and more focused on the short term. Shares are traded with increasing frequency, meaning that their owners are concerned with returns over a period of months rather than years, and business leaders are expected to respond accordingly.

Over the past two decades, there has been a growth in investors, who operate internationally and are not always interested in working closely with the UK companies in which they invest, unlike some UK-based long-term funds.

This has reduced the level of engagement between shareholders and companies, meaning that shareholders are likely to use ‘exit’ (ie selling their shares and investing elsewhere) rather than ‘voice’ (voting in AGMs and engaging with the company management) as a tool for increasing the value of their investments.<sup>35</sup>

Technological changes have exacerbated this trend, with computers and mobile devices making it much easier to keep track of markets and arrange transactions.<sup>36</sup> Fair Pensions, the campaign for responsible investment, also claim that the mis-interpretation of investors’ fiduciary duty combined with short-term performance measurements in the investment chain has increased the frequency of trading.

<sup>33</sup> BAE Systems plc, BAE Systems Annual Report 2011, 81  
<sup>34</sup> Kay Review, p31  
<sup>35</sup> Ibid  
<sup>36</sup> John Kay, the Kay Review of UK Equity Markets and long-term decision-making: Interim Report, Department for Business Innovation and Skills, 2012, p10

**table 1 Historical Trends in Beneficial Ownership (Percentage Held)**

	1963	1975	1981	1991	2001	2008	2010
Rest of world	7	5.6	3.6	12.8	35.7	41.5	41.2
Insurance companies	10	15.9	20.5	20.8	20	13.4	8.6
Pensions funds	6.4	16.8	26.7	31.3	16.1	12.8	5.1
Individuals	54	37.5	28.2	19.9	14.8	10.2	11.5
Other	22.6	24.2	21	15.2	13.4	22.1	33.6

<sup>31</sup> Anglo-American plc, Annual Report 2011, p104

<sup>32</sup> British Sky Broadcasting plc, Annual Report 2011, p49

*'The idea that trustees' duties begin and end with maximising returns, combined with the desire to ensure that duty is fulfilled by regularly holding fund managers to account for their performance, contributes to a focus on quarterly results and pressure for short-term outperformance.'*<sup>37</sup>

Fair Pensions argue that investment fund trustees do not adequately focus on long-term considerations, such as employee engagement or social responsibility, because of an erroneous belief that they are compelled to maximise returns in the short-term.

As such, the pay packages of the fund managers commissioned by trustees to manage their investment are also attached to short-term performance – the returns they generate on a quarterly basis compared to other fund managers. They are therefore incentivised to improve their performance by frequently trading stocks that they expect to rise or fall sharply, rather than investing in companies that they believe will deliver more significant returns in the long-term.

All this means that the average length of shareholding in the UK is now just seven months, down from two years in the 1980s and five years in the 1960s.<sup>38</sup> Therefore, for company executives, delivering shareholder value increasingly means short-term returns to enable a quick profit when shares are sold on in a few months' time.

## Cost-cutting

There are practical examples of major companies who have been damaged by short-term thinking.

The Deepwater Horizon disaster, estimated to have cost BP around \$100 billion, demonstrates the perils of a fixation with short-term returns.<sup>39</sup> The inquiry into the disaster concluded that BP introduced a number of cost-cutting measures that increased risks on the offshore rig. "Whether purposeful or not, many of the decisions that BP, Halliburton and Transocean made that increased the risks of the Macondo blow-out clearly saved those companies significant time and (money),"<sup>40</sup> according to the Congressional report into the disaster. When the disaster occurred, the damage far exceeded the initial savings made by BP.<sup>41</sup>

It is easy to see how the logic of shareholder value could incentivise companies to reduce staff numbers; extend the lifetime of company equipment; reduce customer support facilities; or cut spending on 'unproductive' (in the short term) research and development processes.

But these 'savings' may prove costly to the business in the long-term. A smaller, overworked employee base is likely to be less productive and more prone to mistakes, with less emotional attachment to the company as a result of job insecurity. Older equipment could lead to faulty production processes or costly health and safety incidents. Poor customer service may result in

customers taking their business to rival companies.

While cost-cutting measures can sometimes improve the efficiency of a business, this can often involve a trade-off with productive capacity or resilience, as BP found out. It is clearly not in the long-term interests of the company for executives to be heavily biased towards cost-cutting by the terms of their pay packages.

## Share buybacks

Critics of shareholder value have highlighted in particular, the pernicious effects of share buyback. The proportion of company spending dedicated to buying their own shares has increased significantly in recent years, while spending on Research and Development has undergone a corresponding decline.

FTSE 100 companies spent \$46 billion on share buybacks in 2006.<sup>42</sup> The figure had decreased to about \$22 billion by 2009 as a result of budget contractions stemming from the financial crisis, but this still remains double the estimated \$10 billion spent annually on share buyback in the late 1990s. Over the same period, business investment as a proportion of GDP has fallen from around 12 per cent to 9 per cent, lower than in France, Germany or the USA.

While there is no point in investing for investment's sake, Mariana Mazzucato (looking at global figures) shows that many of the companies that claimed they had no opportunities for

research and development were operating in sectors such as the pharmaceuticals or oil and gas industry, where the scope for innovations relating to new forms of medicine or sustainable energy generation is considerable.<sup>43</sup>

US economist William Lazonick provides an example from the US of how damaging this failure to invest can be. He calculates that the money spent by General Motors on share buyback between 1986 and 2002 would have covered the cost of the \$35 billion bail-out the company received from the US government to stave off bankruptcy in 2009.<sup>44</sup>

As with cost-cutting measures, executives are biased towards practices such as share buyback because their pay packages are attached to company share prices. The share price can be driven upwards by using the company resources controlled by the executives to purchase more shares. These resources could in many cases be used more productively to invest in areas such as staff training, research and development or upgrading facilities and equipment.

When executive pay packages are linked to metrics that can be manipulated through actions that are potentially contrary to the company's long-term interests, there is a clear need for changes.

<sup>37</sup> Fair Pensions, The Enlightened Shareholder: Clarifying Investors Fiduciary Duties, 2012, p6

<sup>38</sup> Professor Prem Sikka, Empowering Shareholders won't Revolutionise Corporate Culture, 19 January 2012 via <http://leap-lrc.blogspot.co.uk/2012/01/empowering-shareholders-wont.html> accessed 13 October 2012

<sup>39</sup> Lynn Stout, The Shareholder Value Myth, 2012, p2  
<sup>40</sup> Guardian, BP cost-cutting blamed for 'avoidable' Deepwater Horizon Spill, 6 January 2011 via <http://www.guardian.co.uk/environment/2011/jan/06/bp-oil-spill-deepwater-horizon>

<sup>41</sup> Shareholder Value myth, p2

<sup>42</sup> Ibid, p3

<sup>43</sup> Institute for Chartered Accountants of Scotland, Corporate Share Repurchases: The Perceptions and Practices of UK Financial Managers and Corporate Investors, 2009, p1

<sup>44</sup> Ibid p1-3

<sup>45</sup> Rebalancing What?, p5

<sup>46</sup> 23 Things they don't tell you about capitalism, p20

## Speculation and acquisition

The dominance of shareholder value and short-term financial performance measures also encourage risk-taking and increased-levels of debt, as companies seek to grow quickly via takeover deals and speculation, rather than slower improvements to the underlying business model.

The Kay Review cites GEC and ICI, the UK's two largest industrial companies at the beginning of the 1990s, as examples of companies whose focus shifted away from developing their core business and instead became pre-occupied with acquisitions designed to deliver immediate financial returns.

<sup>47</sup> Kay Review, p18  
<sup>48</sup> Andrew Haldane, Wincott Annual Memorial Lecture, London, 24 October 2012

*'In the 1990s, ICI responded to stock market pressures by floating its pharmaceutical division and beginning a programme of business disposal and acquisition designed to re-establish the company as a speciality chemical business. The strategy was not successful and the company was acquired in 2007 by AkzoNobel.... (GEC) was seen as excessively focussed on financial targets which resulted in an emphasis on sales in less competitive markets and GEC played little role in the development of new markets in consumer electronics and information technology. After (CEO) Weinstock's retirement in 1996, the new executive team planned to reposition the company in growing markets by an aggressive programme of acquisitions and disposals. As at ICI, this programme was not successful. The share price collapsed and, after a major debt for equity swap, the company was broken up.'*<sup>47</sup>

There are similar examples from the recent banking crisis. Andrew Haldane attributes the pursuit of high returns on equity incentivised in bank managers' pay packages as a critical cause of the crisis. As Haldane puts it:

*'Investors shorten their horizons. They set ROE (return on equity) targets for management to boost their short-term stake. These targets in turn encourage short-term risk taking behaviour. That benefits the short-term investor at the expense of the long-term, generating incentives to further shorten horizons.'*<sup>48</sup>

Haldane suggests that short-term investors benefit from a more volatile economy, where company share prices rise and fall rapidly. They are not really interested in the company's long-term prosperity, because they generate returns from sudden changes in market value. Sharper and more frequent changes give them the opportunity for larger and more frequent returns.

When executive pay packages are aligned with these short-term shareholder interests, then the likelihood of excessive risk-taking is increased. Examples of the kind envisaged by Haldane include RBS's series of debt-funded acquisitions in the early 2000s, or Northern Rock's programme of borrowing to increase the number of mortgages they offered. Both organisations had to be rescued during the financial crisis.

Though Haldane refers specifically to the banking sector and the metric 'return on equity', the same problems could apply to any company run on the basis of short-term shareholder value maximisation, and other financial metrics that can be manipulated by risky takeovers and debt-fuelled growth.

Again, this demonstrates a clear need to measure CEO performance using metrics that are more reliable indicators of long-term, sustainable growth

## Shareholders' paradise

Though 'shareholder value' maximisation is most readily associated with neo-liberal economics as pioneered in the USA, it is arguably more entrenched in the corporate culture of the UK.

Lynn Stout, professor of business law at Cornell university, describes the UK as a 'shareholders paradise' even when compared with America. In the UK the primacy of shareholder interests over all other company stakeholders is interpreted as a legal principle.<sup>49</sup> As has been shown, investment fund trustees in the UK regularly cite their fiduciary duty as a reason for ignoring social responsibility issues.

Similarly, the ACCA report into the Company Law Review interviewed a number of individuals who had participated in the review, and concluded that the review and the subsequent 2006 Companies Act were intended to further entrench shareholder value.

*'What was made very clear to us was that shareholder primacy was the intended outcome – and this was the unequivocal understanding of all the interviewees.'*<sup>50</sup>

The Kay Review suggests that Britain 'is the most open market for acquisitions of any large country.'<sup>51</sup> Kay cites the claims of the Chairman of Cadbury that they did not believe it possible to reject a high bid for the company, even if they thought that it was not in the interests of the company, because they were compelled to accept what was an attractive offer for shareholders.<sup>52</sup>

The British government has focused on strengthening shareholder power as a means of tackling unpopular business practices such as excessive executive pay. New regulations will give shareholders a binding vote on executive pay plans every three years. However, shareholders' say on pay is likely to favour pay packages that are closely linked to share price increases and short-term returns, which can create a damaging corporate culture.

This entrenchment of shareholder value maximisation in the UK raises a number of questions relating to company performance – if shareholders' focus is so short-term, what alternative business objectives would better sustain the UK economy in the long run? In whose interests should businesses be run, and how could executive performance measures reflect this? •

<sup>49</sup> The Shareholder Value Myth, p56  
<sup>50</sup> David Collison, Stuart Cross, John Ferguson, David Power and Lorna Stephenson, Shareholder Primacy in UK Corporate Law: An Exploration of the Rationale and Evidence, ACCA, 2005, p5  
<sup>51</sup> Kay Review, p58  
<sup>52</sup> Kay Review: Interim Report, p13

## What else do companies do? Success is about more than profit

Big business has an enormous impact on society in a wide variety of ways that are not recorded by financial performance measures. In order to understand the value of businesses to the UK as a whole, it is necessary to study what would constitute successful performance in relation to a wide range of stakeholder perspectives and measurements.

### Employee engagement and wellbeing

For example, 24 million people work in the private sector across the UK, with over half of them working for large companies.

As such, a huge number of people's day-to-day lives are shaped by companies: their standards of living are dictated by what their employer pays, and how they are treated by colleagues and management; their future prospects are shaped by employment and training opportunities.

There has been a huge interest in 'wellbeing' as a measure of national prosperity in recent years, with a growing number of mainstream politicians taking an interest in ways of evaluating quality of life beyond narrow financial measures. In France, Nicolas Sarkozy commissioned leading economists Joseph Stiglitz and Amartya Sen to look at ways of measuring national wellbeing. UK commentators such as Adair Turner and Robert and Edward Skidelsky have argued that GDP does not properly measure our success as a society. David Cameron stated in 2010 that:

*'It's time we admitted that there's more to life than money and it's time we focused not just on GDP but on GWB – general wellbeing. Wellbeing can't be measured by money or traded in markets. It's about the beauty of our surroundings, the quality of our culture and, above all, the strength of our relationships. Improving our society's sense of wellbeing is, I believe, the central political challenge of our time.'*<sup>53</sup>

By the same logic, the individual companies that make up the economy as a whole should also consider their value beyond narrow financial measures. So many people spend such a large part of their lives working for large companies that the contribution of those companies to individual wellbeing is critical. Yet this information cannot be captured using the financial performance measures currently in place across most of the FTSE 100.

### Customer care

Many of the arguments used to advocate performance measures that reflect employee interests can also be made in relation to customer satisfaction.

Companies play a key role developing and delivering many of the most essential and life-enhancing products and services available today. Therefore, they exert a major influence on the wellbeing of their customer base, as well as their employees

The use of financial performance measures suggests the successful delivery of products or services is

seen as a means of sustaining profits. It could be argued that the reverse should be true – profitability should be viewed as a means of sustaining the company's ability to deliver life-enhancing products or services.

Many large UK companies are responsible for supplying some of the most important human needs – food, fuel, transport and an increasing proportion of public services. Poor customer service does not make business sense on a long-term basis, and also has a short term impact on consumer wellbeing. If we want businesses to be of practical benefit to society, then performance measures relating to customer satisfaction must be given greater prominence, particularly in relation to executive pay.

### Broader impact

On a macro level, the UK's economic prosperity as a whole depends on factors such as the skill level of the workforce; or the spending power of consumers. These are, in part, contingent on the levels of training, employment and remuneration offered by individual companies.

Private sector funding for R&D and the capacity for companies to innovate contributes to the UK's economic dynamism and potential for future growth. The Kay Review identifies the decline of business investment as a proportion of GDP, relative to France, Germany and the USA, as a future strategic economic threat.<sup>54</sup>

Business also makes a vital contribution to UK tax revenues. The UK's public spending deficit ballooned in 2007 in the aftermath of the financial

crisis, as tax receipts from the financial services sector collapsed.

Given the potential economic damage that individual companies can do to communities, or to the UK as a whole, it therefore makes sense that measures of company performance record their impact, or the threat they pose, in this regard

### Business owes society

This provides the practical justification for society's stake in company performance. But there is also a moral case. Society as a whole bears the cost of a number of the negative externalities generated by companies. The business sector accounted for 31% of UK Greenhouse Gas emissions in 2010 (the most recent year for which end-user figures are available).<sup>55</sup> Excessive levels of executive pay awarded by large companies increase inequality and thereby make a significant contribution to the myriad of social problems - including poor public health, low levels of trust and a higher prison population – that occur in more unequal countries.

Practices such as tax avoidance; reductions in staff costs and training budgets; or the use of cheaper but environmentally damaging business processes can all lead to increased, short-term profitability and higher returns to shareholders, but create costs elsewhere that must be borne by the population as a whole through avoidable public spending funded by general taxation. Thus, it is entirely possible that a business could be performing successfully according to the

<sup>53</sup> Guardian, David Cameron aims to make happiness the new GDP, 14 November 2010 via <http://www.guardian.co.uk/politics/2010/nov/14/david-cameron-wellbeing-inquiry> accessed 13 October 2012

<sup>54</sup> Kay Review, p15  
<sup>55</sup> Department for Energy and Climate Change, UK Emissions Statistics via [http://www.decc.gov.uk/en/content/cms/statistics/climate\\_stats/gg\\_emissions/uk\\_emissions/uk\\_emissions.aspx](http://www.decc.gov.uk/en/content/cms/statistics/climate_stats/gg_emissions/uk_emissions/uk_emissions.aspx) accessed 1 November 2012

prevailing performance measures used across the FTSE 100, yet still have an overall damaging effect on society. Measures that record the environmental and socio-economic impact of our biggest companies are clearly vital to understanding their overall value. If these measures determined the size of executive pay packages, then it is likely that the improvement of society as a whole would be a much higher priority for UK businesses.

In addition to covering these on-going costs resulting from the negative externalities produced by large companies, society also plays a key role in generating business in the first place. Mariana Mazzucato highlights the important but understated role that state funding played in the development of technologies vital to recent growth in key business sectors. She asks:

*How many people know that the algorithm that led to Google's success was funded by a public sector National Science Foundation grant? Or that molecular antibodies, which provided the foundation for biotechnology before venture capital moved into the sector, were discovered in public Medical Research Council (MRC) labs in the UK?*<sup>56</sup>

Mazzucato's paper notes that the state plays a more prominent role in R&D in the US, where it accounts for 57% of basic R&D funding. Even in the UK however, the Government provides 32 per cent of R&D funding,<sup>57</sup> compared to 44 per cent provided by businesses. The contribution of government-funded research to sectors such as health and pharmaceuticals; or defence and aerospace is significant. The growth of technology businesses

in 'silicon fen' around the University of Cambridge, funded, in part, with public money, demonstrates the importance of government support for industry. Research carried out at the University, and its liberal attitude towards its intellectual property, have been crucial to the development of a thriving business cluster.

This funding for R&D is in addition to the more general infrastructure, provided or guaranteed by the government, that enables businesses to thrive – roads and public transport networks, schools and universities, publicly-funded healthcare, the rule of law and a stable economy that maintains steady growth in consumption.

While certain narratives depict wealth-creation as the work of individual entrepreneurs or intrepid companies, the truth is far more complex. Government may derive its resources from individual households or companies, but it also generates wealth on their behalf as an aggregator, co-ordinator and investor on a scale that is vital to collective prosperity yet impossible for private individuals or organisations to achieve in isolation.

Therefore, Government should be seen as a key stakeholder in business performance, not only because of the impact of businesses on wider society, but also because businesses depend on publicly funded research and infrastructure. So company objectives and executive performance measures should reflect the public interest, as well as the interest of their shareholders. •

## Conclusions and Recommendations

Business leaders are encouraged to increase profits over the short-term with a focus on returns for shareholders. The executive pay packages that are attached to narrow financial metrics like Earnings per Share or Total Shareholder Return, are a direct result of the view that ultimately shareholders are the only constituency that matters to a business.

In many cases, these pay packages have incentivised decisions that have not turned out well for the company in the long-term, even in financial terms, let alone the environmental and social damage that can result from a disregard for business's wider responsibilities.

This model needs to be fairer and more sustainable. Companies should widen their objectives beyond the narrow focus on shareholders to reflect the interests of all the stakeholders who are affected by the company's activities and who contribute to its success. Executive pay packages should reflect a similar balance of interests.

**Recommendation 1:  
At least 50% of executives' performance-related pay packages should be tied to non-financial metrics such as employee engagement; customer satisfaction and; corporate social and environmental performance**

The High Pay Centre remains sceptical of performance-related pay – the academic evidence looking at whether or not it actually improves performance is mixed.

Therefore, we believe that overall performance-related-pay, which can be around 900% of base salary, should form a much smaller proportion of total pay packages.

If performance-related pay is to continue, it should be much less complex, with one performance-related plan as part of the package, judged against a small number of measures that are clearly defined and quantifiable. At least 50% of the performance-related element should be attached to the underlying non-financial measures of company performance, that give a true picture of an executive's achievements, rather than the headline financial figures. This could be enshrined by the Financial Reporting Council in the UK's corporate governance code.

Many mainstream shareholders are starting to recognise that short-term financial performance is not the only measure of company success. They have suggested that measures such as employee and customer relations, or corporate social performance should have a much greater weighting in judging a company's success. The Association of British Insurers recently called for more non-financial measures in executive pay packages.<sup>58</sup> Paul Polman, the Unilever CEO has said that

*'We need new business models ... that take into account not just the economic but the sustainable and equitable parts of growth.'*

Attaching non-financial performance measures to executive pay packages would not be a

<sup>56</sup> Mariana Mazzucato, The Entrepreneurial State, Demos, 2012, p19  
<sup>57</sup> Ibid p51

<sup>58</sup> Guardian, Curb executive pay rises, insurers tell top companies, 26 November 2012 via <http://www.guardian.co.uk/business/2012/nov/26/curb-executive-pay-advise-insurers>

complicated process – many companies undertake independent audits of their employee and customer engagement.

Companies such as BT Group (for customer satisfaction) and Centrica (for employee engagement) already factor non-financial performance into their executive pay packages. Currently, they only account for a small proportion of their total pay package, but there is no reason why this could not and should not be increased, provided remuneration committees who set pay, exert vigilance to prevent executives from using them as a means to secure high pay packages when financial performance has been poor.

The primary argument against these measures is that they are subjective, and do not provide a single 'bottom line' indicator of company/ executive performance, nor is there a single non-financial performance

measure that gives a definitive overall verdict of the company. This is debatable – it could be argued that certain non-financial measures like brand perception or customer satisfaction, for example, provide a more fundamental gauge of sustainable success than earnings or share price. A comprehensive environmental or social balance sheet such as that pioneered by Puma records a company's value to society as a whole more accurately.

Perhaps as importantly, it is clear that the charge of subjectivity is at least as applicable to the prevailing financial measures currently used to calculate executive pay, and that indicators such as EPS and TSR reflect a very narrow conception of company success.

Pay attached to stakeholder interests would also establish a clear principle that company executives have a responsibility to all those who contribute to a company's wealth and are affected by its actions. Executives would be rewarded for leading companies that make a net contribution to society, rather than ones that extract value from it.

**Recommendation 2:  
Companies should be required to report on employee engagement; customer satisfaction; and social and environmental performance**

Stronger requirements on the disclosure of non-financial reporting would support the use of non-financial performance measures

in top pay packages. Putting standardised, readily comparable non-financial data in the public domain would create pressure on companies to prioritise performance in these areas. It would also enable them to use this data to measure executive performance.

A model for implementation of mandatory reporting already exists in France, where the New Economic Regulations (NRE) have mandated social and environmental reporting for listed companies since 2001. Prescribed quantitative performance measures relate to employee relations and environmental impact. Companies are also compelled to include qualitative narrative reporting on areas such as employment policies; environment management; human rights; and community relations. This mirrors the two tier reporting structure envisaged by the coalition government for the UK.

Research by Elise Perrault Crawford and Cynthia Clark Williams; and by Mary-Lou Egan et al found that though compliance with the NRE was not universal, mandatory reporting had significantly improved disclosure of social and environmental performance; and made sustainable development a more integral part of French companies' business models.<sup>58</sup>

These requirements could be implemented as part of the new framework on narrative reporting that the Government is developing. This involves a 'strategic report,' providing an over-arching

narrative of business prospects, plus a more detailed 'Annual Directors Statement' featuring specific, comparable, quantitative information.

The Strategic Report could require companies to provide qualitative information describing their relationships with employees; customers; suppliers/partners; and society. This should cover past performance and forthcoming challenges in these areas with particular reference to public trust; brand development; long-term business strategy; de-carbonisation and sustainability; and compliance with relevant business or environmental legislation.

The Annual Directors' Statement should mandate specific quantitative non-financial data in order to validate the information on stakeholder value outlined in the Strategic Report.

This should include the following criteria, reflecting requirements that currently exist in France, or have been advocated by campaigners for socially responsible business:

- > Staff turnover and Staff absences
- > Pay differential between highest paid employee and the median
- > Working days lost to injuries sustained in the workplace, and deaths in the workplace (if applicable)
- > Consumption of water, energy, raw materials/natural resources; and use of land throughout supply chain
- > Emissions of wastes into air, water, and land, including Greenhouse Gas emissions, throughout the supply chain

### Puma profits

Puma have developed an environmental profit and loss account, designed to calculate their resource use and Greenhouse Gas emissions from their entire supply chain. Puma CEO Jochen Zeit said he believed that the audit would ultimately be to the company's commercial advantage:

'I think there is no way around it for businesses that have long term view and that believe in building brand equity long term rather than quarter-by-quarter. I believe that regulation will also kick in and environmental profit and loss will become a standard because it's such a powerful idea that you can't ignore it. I believe that either way, push or pull, it's going to happen.'

<sup>58</sup> Elise Perrault Crawford and Cynthia Clark Williams, Should corporate social reporting be voluntary or mandatory? Evidence from the banking sector in France and the United States in Corporate Governance, Vol 10, No. 4, 2010, p512-526; and Mary Lou Egan, Fabrice Mauléon, Dominique Wolff and Marc Bendick Jr, France's Mandatory "Triple Bottom Line" Reporting: Promoting Sustainable Development through Informational Regulation in The International Journal of Environmental, Cultural, Economic and Social Sustainability, Volume 5, No. 5, 2009, p27-47

- > Investment in Environmental Management
- > Investment in Research and Development, and staff training
- > Tax paid in the UK
- > Fines paid to Governments for business or environmental violations

These would not represent an onerous set of requirements. There is a clear public interest in knowing the impact that individual companies have in these areas, and the measures cited are universally applicable across sectors. It is also in the interests of companies and their shareholders to collate this information and maintain it in order to analyse potential threats to the brand or customer/employee loyalty.

**Recommendation 3: Tax rates and government procurement criteria should be used to encourage non-financial disclosure**

Compliance with the New Economic Regulations in France has been impressive, but not universal. If, like France, the UK chooses not to enforce mandatory reporting through judicial means, there are a number of other levers open to the Government in order to encourage full disclosure.

Corporation Tax is the most obvious incentive. It would be relatively simple to introduce a reduced tax rate for companies that commit to reporting against all the indicators that we describe above.

This would reflect a clear and understandable principle of fairness. Companies that disclose

their impact on society initiate a dialogue with their wider community of stakeholders that can lead to improved social and environmental outcomes. They should be subject to lower rates of taxation than those companies that refuse to consider the environmental and social costs of their actions and therefore impose a higher cost on society as a whole

The Social Value Act which comes into effect in January 2013 also provides a framework within which the government's huge procurement budget could be used to further promote social and environmental reporting. Government is currently required to achieve best value when awarding contracts for public service works. The Act recommends that 'best value' should be understood in terms of the social, environmental and economic outcomes arising from a contract award, not just the cost of the service provided. So, for example, an organisation that undertakes to pay the living wage or provide apprenticeships or run the service on a carbon neutral basis as part of their offer may be considered better value than a competitor bidding for the contract at lower cost.

Disclosure on employee engagement; customer satisfaction; and social and environmental performance are vital to achieving social value – companies willing to engage in these areas are likely to have a much more positive impact on their communities, and should therefore be favoured by contract-awarding public bodies. This would hugely increase the importance that companies attach to non-financial performance. Many of the FTSE 100

constituents generate a substantial amount of business from the public sector – service providers; the defence industries; construction and engineering firms; or energy companies.

If reporting on non-financial measures increased their likelihood of winning government contracts, this would represent a significant incentive to comply with the reporting requirements that we propose.

**Recommendation 4: Pension fund trustees, investment managers and commercial pension providers should take into account social and environmental concerns when making investment decisions**

In addition to encouraging the use of specific non-financial performance measures, government could create a business climate that facilitates the adoption of non-financial business objectives more generally.

Incorporating social and environmental concerns into investment decisions is a key part of this. Investors currently argue that they are legally obliged to maximise returns, even when the wider consequences for the beneficiaries are negative – for example, dangerous climate change arising from investment in energy intensive businesses; the economic damage concentrated in geographic areas resulting from a ruthless cost-cutter shutting down a major employer; or the damage done more generally by market volatility resulting from short-term trading.

A revised fiduciary duty would embed the use of non-financial performance measures along the investment chain, thereby encouraging their use throughout the economy. It would also allow pension fund trustees to take a longer-term perspective, on the basis that longer-term investment is more socially/environmentally responsible. This would reduce the need to benchmark fund-managers on a quarterly basis in a way that encourages frenetic trading activity measured solely by short-term share price movements, rather than the wider impact of investment decisions.

**Recommendation 5: Employees should have a company-wide advisory vote on executive pay packages, and non-executive representation on company boards**

It is vital that a wider range of stakeholder interests are included in corporate governance structures, to combat the obsession with shareholder value and ensure that a company's performance is understood in terms of its value to society as a whole. We argue that employees are the stakeholder community best suited to this role.

Employees have arguably a much greater stake in a company's sustained success than shareholders, because their livelihoods depend on it and their risk is not spread among other investments.

Therefore, they have far more to lose if the company fails. As company employees invariably live in the community in which the company is situated, they



are also likely to be concerned with reputational issues arising from poor social or environmental performance. So they represent a closely-aligned and feasible proxy for the interests of wider society in company performance.

For example, employee representatives concerned with a company's long-term sustainability would have an interest in challenging short-termist practices such as stock buyback, or cuts in research or staff development budgets. They would be unlikely to accept inequitable executive pay packages that are many times what they themselves earn.

Employee representation already works successfully in Germany, which is home to 32 Fortune 500 companies across industries including the manufacturing, automobile, energy and financial services sectors amongst others. This suggests that the fear of employees on boards is unfounded, and that the policy could be equally effective in developing a longer-term outlook and broader definition of company success in the UK.

## Conclusion

The central argument of this report is that narrow financial performance measures do not encourage sensible long-term stewardship of a company, nor do they accurately portray its past performance or future prospects.

Businesses focus on earnings per share and total shareholder return to gauge company performance

and effectively executive pay incentives. But they fail to measure the benefit of companies to society beyond a narrow constituency of shareholders.

Many of the coalition government's reforms to corporate governance rely entirely on shareholders as agents of reform. Proposals to address the market failure on executive pay rely on a binding shareholder vote on pay, while the new narrative reporting regulations are intended

*'to provide the information shareholders need to understand how the companies they invest in are being run.'*<sup>59</sup>

But the changing nature of share-ownership, with a higher proportion of international investors; short-term traders; and diverse portfolios means that shareholders cannot always be relied upon to take a long-term interest in the sustainability of individual companies, or their impact on wider society.

The measures that we propose to address this should not be seen as an additional regulatory burden on companies, but as a package of stability mechanisms designed to help them develop a long-term, sustainable focus. Though well-intentioned, constant talk of 'red tape' creates the impression that the major corporate disasters of the past two decades – ICI, GEC, BP, RBS, Northern Rock, Lloyds/HBOS – were caused by stifling regulation, rather than weak corporate governance; poorly-structured incentives that

encouraged excessive risk-taking; and a mis-guided understanding of business objectives.

A revised conception of what constitutes good company performance supported by the policy changes proposed in this paper would go some way to addressing these structural flaws. •

<sup>60</sup> Department for Business, Innovation and Skills, The Future of Narrative Reporting: the Government Response via <http://www.bis.gov.uk/assets/BISCore/business-law/docs/F12-588-future-of-narrative-reporting-government-response.pdf> accessed 13 October 2012

