Performance measures, benchmarks and targets in executive remuneration contracts of UK firms

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A B S T R A C T

This paper is a descriptive analysis of performance measures, benchmarks and targets in remuneration contracts for a sample of 1269 plans from 440 UK firms for 2002/2003. Data were collected from the remuneration reports that became a mandatory disclosure following the Directors’ Remuneration Report Regulations (2002). The descriptive analysis is divided into two main sections. In the first section, performance measures and benchmarks employed are examined. Consistent with earlier analyses of performance measures (Conyon et al., 2000; Conyon & Murphy, 2000; Pass, Robinson, & Ward, 2000), earnings per share (eps) and total shareholder return (TSR) are the two most popular measures, with share option plans often employing the former and LTIPS the latter. However, it is also possible to observe a shift in the popularity of LTIPs over share options since 2002. When investigating the choice of performance measures used in plans, there is evidence that suggests underlying volatility in the performance measure can affect its being chosen, but this is overridden by instances of mimicry and institutional isomorphism (Di Maggio & Powell, 1983). The second section provides a descriptive analysis of targets set in a sub-sample of plans that employ eps as a performance measure. Here, targets tended to cluster around levels that have been prescribed in guidelines, which again suggests that a certain degree of isomorphism is present. Also, plans tend to have targets lower than past and forecasted performance, and targets set were met six times out of ten. The use of lower and upper threshold targets helps control attainability, but less than half of plans specify an upper threshold target. Observations suggest that the remuneration setting process falls victim to institutional isomorphism in the absence of clear and concrete guidelines regarding what is considered acceptable.

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1. Introduction

The use of performance targets in executive remuneration plans in the UK was first suggested in the Greenbury (1995) Report and has become a common feature of cash based, share option and other share-based long term incentive plans (LTIPs). However, it was only after the enforcement of the Directors’ Remuneration Report Regulations (DRRR) in 2002 that firms were required to disclose performance measures, targets and related benchmarks to their shareholders. Prior to this, performance levels against which executives were assessed as part of their remuneration payout were highly opaque (Bruce, Buck, & Main, 2005). The introduction of the mandatory remuneration report in firms’ annual reports sheds some light on the target setting process at the executive level of UK firms.

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This paper presents a descriptive analysis of the key performance elements in executive remuneration plans – such as performance measures, performance benchmarks and performance targets – as used by a sample of 440 large UK companies in the year 2002/2003. It extends earlier work examining performance measures and targets by Conyon and Murphy (2000), Conyon, Peck, Read, and Sadler (2000) and Pass, Robinson, and Ward (2000) by documenting the performance measures used in remuneration plans up to 2003, and the targets and benchmarks used in conjunction with these metrics. In addition to updating existing work, this paper provides a more detailed analysis of performance measures, benchmarks and targets which have yet to be rigorously analysed in the literature, particularly performance targets which were not always disclosed before the DRRR (2002).

The descriptive analysis is based on 1269 individual remuneration plans, consisting of annual bonus plans, share option plans, long-term incentive plans, and other plans such as deferred bonus plans for executive directors from 440 large UK firms. All data were manually collected from firms’ remuneration reports published in the annual report to shareholders for the fiscal year 2002/2003 (firms with reporting dates of 31 December 2002 and onwards). In addition to requirements of the DRRR (2002), the Combined Code (2000) was also in effect during the time this study was undertaken.

The first part of the descriptive analysis presents observations of performance measures and benchmarks used in remuneration plans. The findings show a similar picture to those in earlier studies, suggesting that the landscape of remuneration plans has not drastically changed although the weightings between components of pay have varied. The discussion of performance measures explores the notion of mimetic isomorphism (Di Moggio & Powell, 1983) in the practice of choosing performance measures and contrasts this against potential economic motivations. It is found that the strength of economic motivations decreases when the analysis is performed on similar plan types and within similar industries. Coupled with observations that certain plan types tend to use certain performance measures, this suggests that there is a degree of mimicry present when firms choose performance measures.

In the second part of the descriptive analysis, eps targets in performance plans are examined using a subset of 291 plans that employ eps growth as a performance measure benchmarked against growth in the Retail Price Index (RPI). Existing evidence tells us that while analysts predict an average three-year median EPS growth of 38% for FTSE 100 firms in 2004/2005, less than 2% of firms set targets that exceed this (Halliwell, 2004). Findings from the sample show that a large proportion of firms set three-year targets of between RPI + 2% p.a. and RPI + 3.99% p.a. The same pattern is observed even when the sample is stratified by plan type. A little over half of the plans in this subset have eps targets set lower than their past eps growth, and 72% of the plans have eps targets set lower than analysts’ forecasts of what they will achieve.

This paper provides an in-depth descriptive analysis of performance measures, benchmarks and targets. However, care must be taken in ascribing causality and assigning correlations among the variables. Certain patterns can be clearly observed but these need to be interpreted in the context of a snapshot of the structure of remuneration plans at the time of the study and may vary from time to time.

The remainder of this paper is structured as follows: the following section discusses the theoretical background of the paper, findings of prior research and the motivation behind the study. Section 3 discusses the sample and data collection process, the descriptive analysis of performance measures are presented in Section 4 and targets in Section 5. The final section concludes.

2. Theory, prior research and motivation

The separation of ownership and control observable in firms today requires remuneration contracts to be written in such a way that encourages executives to act in the best interest of the shareholders (Jensen & Meckling, 1976). These contracts often specify the measures against which executives are assessed, and the appropriate targets that are to be achieved in order to trigger rewards, whether in the form of cash bonuses, stock options or share issues. The performance measures are agreed upon beforehand, and are predominantly expressed as either accounting or share-based measures (Conyon et al., 2000; Pass et al., 2000). Targets are often negotiated via processes initiated by the remuneration committee. Three bodies of literature are examined in this literature review: those that chart the changing shape of executive remuneration, especially in the UK, the choice of performance measures and issues related to target setting.

2.1. The shape of current executive remuneration practices

The generic Anglo-American executive remuneration plan has a salary component, a bonus component (discretionary or performance linked), a long term incentive component (share options, deferred bonuses, restricted shares and similar items), a pension component and benefits in kind (Conyon et al., 2000; Conyon, Fernandes, Ferreira, Matos, & Murphy, 2011; Murphy, 1999). However, the composition of pay elements may differ between the plans of US and UK firms, where it is typically observed that share option plans are more popular in the former and share grants (LTIPs) more popular in the latter (Conyon, Core, & Guay, 2011). This can be attributed to various factors. Conyon, Fernandes, et al. (2011) and Conyon, Core, et al. (2011) argue that while there are economic explanations behind changes in both the structure and the level of executive remuneration, the influence of tax policies and changes in legal regulations and accounting standards also play a significant role. The authors conclude that the key event that saw the explosion of share option use in the US was a change in the tax policy that resulted in salaries over US$1m not being tax deductible, resulting in firms shifting to remunerate their executives using
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