With manager performance metrics, the tricky question is how to reward long-term thinking

Wim A Van der Stede discusses the advantages and pitfalls of return metrics vs profit ones

Some time ago I was asked to comment on a study that found that the use of *accounting return measures* and *non-financial measures* in bonus plans was associated with managers' long-term focus. This suggests that proper performance measurement systems can affect managers' horizon and alleviate myopia.

Myopia is indeed a pervasive issue in business, as the Kay Review suggests (amongst countless others). The blame is often squarely on performance measurement (e.g., Kay, p. 75): "Ratios such as earnings per share and return on equity can be influenced by reducing the denominator rather than by increasing the numerator, so that these metrics can show positive returns even if the underlying value of the business is only maintained or even reduced."

Evaluating managers on the basis of accounting *profits* will predictably provide incentives to increase short-run profits by cutting new product development, training, etc. even if doing so reduces value long term. While the counterproductive effects associated with accounting performance measures are well understood, Murphy & Jensen argue, like Kay, that "*even-worse problems* are created when these measures are expressed as ratios or rates of return" (p. 29). To lay it on thick, Murphy & Jensen (p. 32) state that "*if it is a performance measure and a ratio, it is wrong*."

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How does that jibe with the finding that I was asked to discuss, showing that *accounting return measures* have an even greater beneficial effect on managers' long-term orientation than *non-financial measures* (presumably because including a cost of capital notion makes accounting return measures different from profit measures in affecting managerial long-term orientation)?

They have a point (although up to a certain point only). Indeed, while accounting *profit* measures take both (but only) revenues and expenses into consideration, they ignore the cost of the capital employed. As such, accounting profit measures provide incentives to invest in any project that earns a profit, but not necessarily earns more than the cost of capital. Conceptually, then, any measure that *also* takes into account the cost of capital must be more 'complete' and, therefore, more 'congruous' with long-term value creation. By implication, firms that are concerned about the long term should put relatively more weight on accounting *return* measures than on *profit* measures.

That is, however, assuming that the operational features of the measure and the implementation of the performance measurement system do not undermine this conceptual logic. And there are two dials to this: whether or not the 'return' measure is expressed as a ratio (rather than as a residual income measure) or vis-à-vis a target.

If the measure is expressed as a ratio, one could argue that managers are possibly more likely, but certainly vastly more able, to scupper the long term intended focus than with profit measures, as indeed they now have both a numerator *and* denominator to play with to try and meet their target — which perhaps is the reason why Murphy & Jensen deem return measures *even worse*. In banks, Andrew Haldane at the Bank of England similarly condemned ROE measures as having contributed to short-termism, arguing that they have led to excessive gearing [i.e., more numerator with less denominator] which for "longer-term investors is a road to nowhere" (p. 12), because it causes managers to "put risk ahead of return and short-term ahead of long-term performance" (p. 13). This of course gets exacerbated when the targets set for returns (or expectations from executives or shareholders) are more challenging.

So here is the irony. Whereas return measures may helpfully invoke a level of awareness about returns in managers' minds, rather than merely a preoccupation with profits, it is not clear that such awareness

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by itself will be enough to curtail short-termism. Worse, managers held accountable in their performance evaluations for ratio-type return measures may actually have extra ammunition to act myopically in their decision making as they can now focus not only on trying to increase the numerator (accounting profits), but also may be tempted to try and decrease the denominator. *When they do*, value is likely to suffer.

But *will they*? Can we assume that the informational effects of awareness about returns will dominate any motivational effects triggered by concerns to meet or exceed return targets? I reckon it may not. The right measurement focus (awareness of returns) undoubtedly is a good start, a necessary but unlikely sufficient condition to mitigate myopia. Particular elements of incentive system design (especially targets and the pressure to meet them), and the extent of decision rights over capital investments, are likely to remain the more potent drivers. Part of the issue can be alleviated by using non-ratio return measures, such as value-added or residual income measures. Surely, accounting return measures of *any* type under any condition aren't quite like the ropes that tied Ulysses to the mast to resist the call of the sirens.

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Notes:

- *This post gives the views of the author, and not the position of LSE Business Review or the London School of Economics.*
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