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Measuring performance
KPIs and the link to strategic objectives

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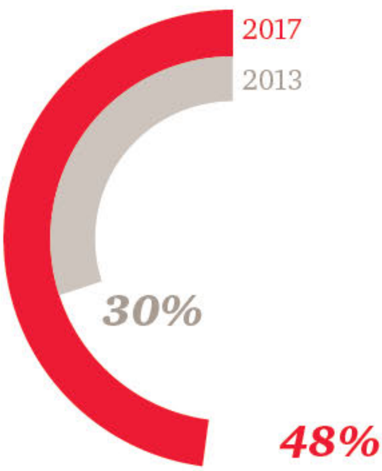
When the FRC introduced their strategic report guidance back in 2014, they highlighted that '*Where relevant, linkage to and discussion of key performance indicators (KPIs) should be included in any descriptions given in order to allow an assessment of the entity's progress against its strategy and objectives*'. However our annual review of reporting in 2016[1] noted that it is still a minority of companies that are successfully demonstrating how strategic objectives link to other parts of the report.

[1] Being distinctive, strategic and relevant: The ongoing challenges in corporate reporting

Figure 1: % of the FTSE 100 providing explicit linkage of KPIs to strategy

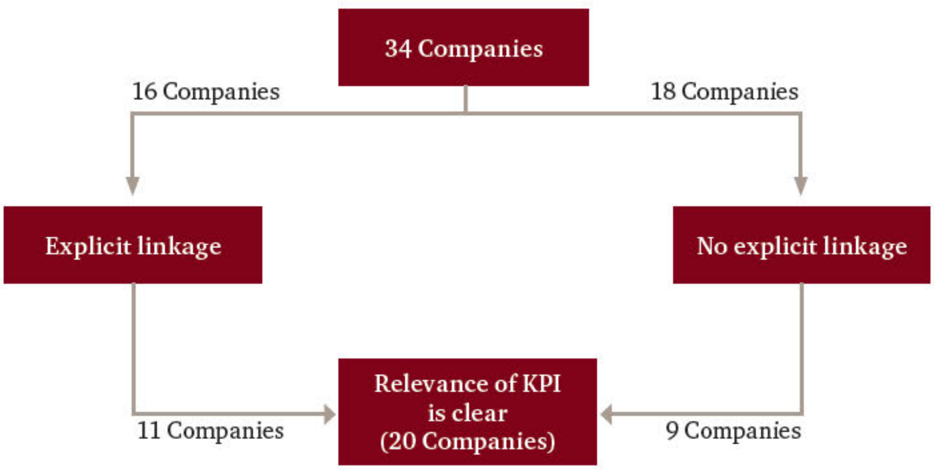


Linkage of KPIs to strategic objectives

We consider linkage of KPIs to strategic objectives to be a key pillar of effective reporting and is a statistic that we have reviewed over the last four years. While there has been an improving trend with 48% of the FTSE 100 (30% in 2013) now explicitly demonstrating linkage of KPIs to strategy through positioning them alongside each other or using symbols to show the relationship, there is clear room for improvement. But just because companies explicitly link their KPIs and strategic objectives does this mean they make strategic sense or is it just use of good design? And equally just because they aren't explicitly linked does this mean they aren't strategically relevant?

We recently looked at a sample of 34 companies in the FTSE 350 which, as illustrated below, showed that, of the 16 companies that explicitly link their KPIs to strategic objectives, 11 aligned each KPI to a single corresponding objective. Where the KPIs were aligned to a single objective the relevance of the KPIs to the strategic objectives was clear but where the KPIs linked to more than one strategic objective, the relevance was less clear. Of the 18 companies that did not form an explicit link, the relevance of the KPIs to the strategic objectives could be inferred by the reader based on the supporting narrative for nine. This means that for 41% (14 companies) of those companies sampled, the relevance of the KPIs to the strategic objectives is unclear.

Figure 2: Analysis of current KPI reporting



How strategically relevant are KPIs?

The analysis on the previous page poses a number of questions. Not least:

- How strategically relevant are the KPIs?
- Is the KPI reported because it measures the progress against the strategic priority or whether its reported because the data is readily available or required by regulation?

This is particularly noticeable for non-financial KPIs where the strategic relevance is often not clear. The strategic report regulations state that *'the review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters' (s414C(4)(b)).*

As illustrated with some specific, widely used non-financial topics on the following page, our analysis has identified that, while 72% of the FTSE 350 report non-financial KPIs, with many inferring in the narrative that they are strategically important, the description of the strategic objectives or the KPI itself, does not always highlight the link between the KPIs and strategic objectives.

Is lack of linkage just a reporting issue though? The relationship between the measures management monitor internally and the measures that are reported externally is a conversation we often have with clients and it is clear to us that these inconsistencies run deeper with KPIs reported externally not always appearing as part of Board discussions.

It is clear to us that the individuals involved in the reporting process and the data that supports it often operate in silo to day-to-day management. And the reporting of KPIs, where those disclosed are often not part of exec/board discussions, is no different.

It is possible that there are reasons why certain KPIs are reported, for example because they are easily measurable, the data is already available or already reported on to meet other regulatory requirement, or even just that management has confidence in the data so is comfortable reporting it externally.

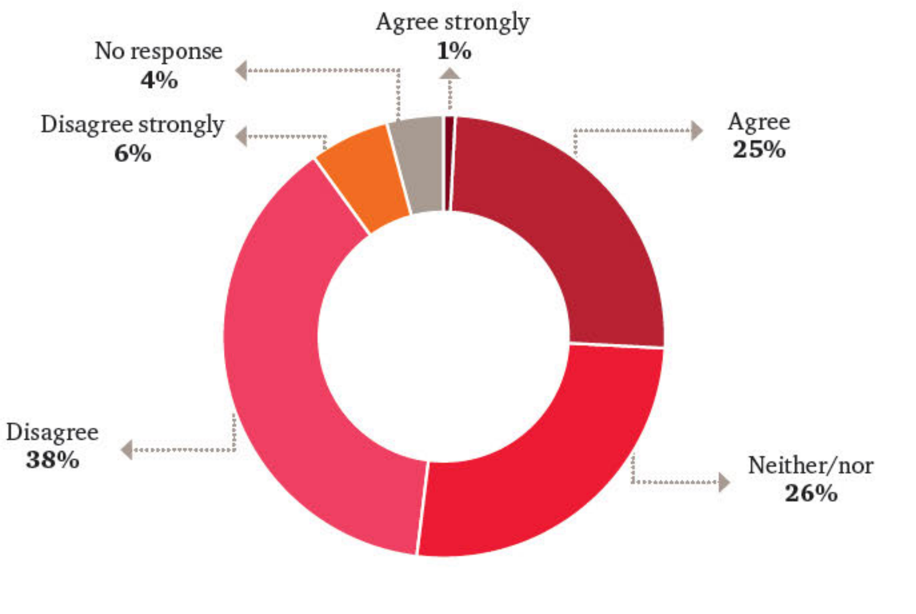
But we believe that, with the exception of commercially sensitive data, external measures should be more consistent with their internal ones. Otherwise what picture does a company's reporting paint of management's strategic decision-making?

We therefore believe a real opportunity exists for companies to provide a clearer link in their KPI reporting – from internal to external, and strategy to incentives and performance.

We asked investors for their view in our 2017 Global investor survey, which identified that only 26% of UK investors agree that management are sufficiently transparent about the metrics they use internally to plan and manage their business (See Figure 3). But how much of this is due to the need for improvement in the quality of existing disclosures and lack of connectivity and relevance?

The FRC's Guidance on the Strategic Report states that *'The KPIs used in the analysis should be those that the directors judge to be most effective in* ***assessing progress against objectives or strategy****, monitoring principal risks, or are otherwise utilised to measure the development, performance or position of the entity'.*

Figure 3: I believe management is sufficiently transparent about the metrics they use internally to plan and manage their business



KPI relevance

Our overview of the KPIs used in three key non-financial areas leads us to question whether many of the measures provided by companies are actually key – do they really allow management to judge strategic success and progress against goals or are they merely statistics? Could the company provide better insight with KPIs that focused on outcomes of their actions and activities rather than simply quantitative facts?

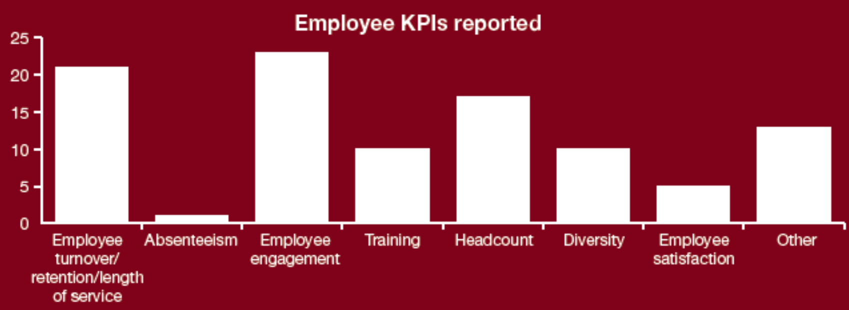
Employees

Many companies talk about their employees being a key part of their business and they are also a Group widely recognised as being a key reader of the annual report so it is not surprising that most documents include employee insights. Yet our findings on employee strategies and KPIs surprised us:

- Only 79 companies (23%) in the FTSE 350 have an explicit employee strategic theme. These tend to fall into 3 categories – high performance culture, employee development and attraction and retention of employees.
- By contrast 106 companies (30%) have one or more employee KPIs. Employee engagement is most common with employee turnover and headcount also proving popular.
- Only 35 companies with an employee KPI have an employee strategic theme.

We can see that whilst there is commonality between the categories of strategic themes and the most popular KPIs, companies don't always explain how the KPI they have chosen represents a measurement of performance.

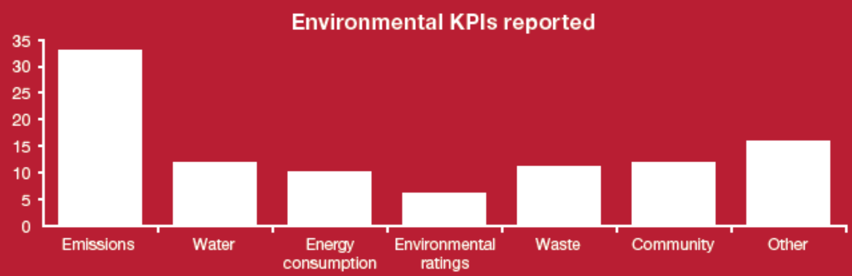
For example does reporting on number of employees receiving training actually show development or do we need to understand if training was successful and saw improvements in productivity? Likewise does headcount in itself demonstrate the success of a retention strategy?



Environmental

Today's companies are much more aware of the impact of their business on the environment. For some, this is a crucial component of their operations, whilst for others it is simply about being a responsible business.

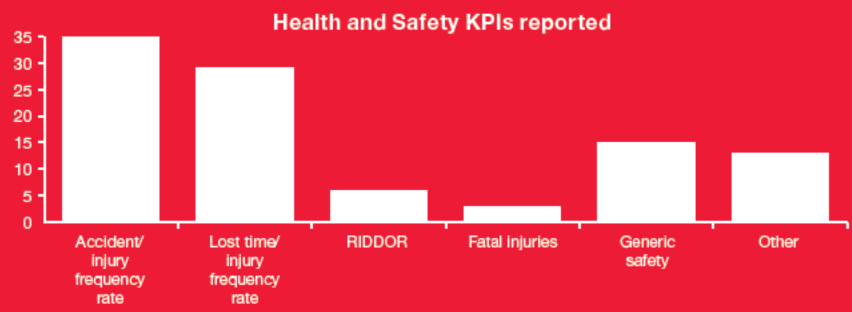
- Our research identified that 46 companies (13%) have an explicit environmental strategic theme.
- Almost twice as many companies (87 – 25%) have at least one environmental KPI. The majority of these concern emissions which must be reported on as a regulatory requirement, but this doesn't have to be a KPI.
- 24 companies who have an environmental KPI also have an environmental strategic theme.



Health and Safety

The wellbeing of employees is something that many companies report on within their annual report as part of their stakeholder engagement.

- 100 companies (29%) have at least one specific KPI relating to health and safety, and the majority of these companies are in specific industries such as engineering and construction or energy, mining and utilities.
- 44 companies that have a health and safety KPI also have a strategic theme on health and safety.



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