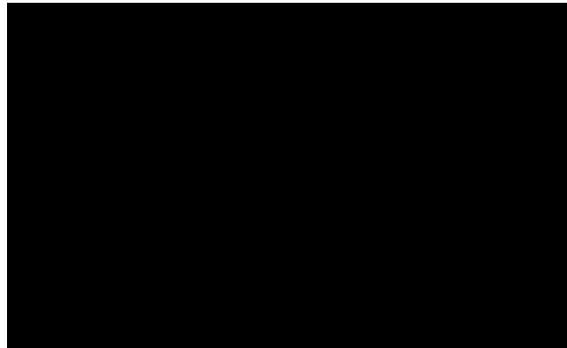


Bank Compensation and Financial Performance Measures: How Objective?



October 2019

Keywords: Banks, executive compensation, non-GAAP earnings

JEL codes: J33, M41

This research was supported by an Australian Research Council Discovery Grant. The authors gratefully acknowledge financial support from the UTS Business School.

Data: All data used are from publicly available commercial data providers as identified. The authors cannot make this data available directly due to commercial licence restrictions.

* Contact Author: UTS Business School
University of Technology Sydney
Sydney NSW 20007
Australia



Abstract

We survey the use of financial performance measures in determining executive pay among significant Australian financial institutions. We document evidence of the emergence and pervasiveness of externally disclosed non-GAAP financial measures also being used internally to determine variable remuneration, with the apparent popularity of cash profit after tax in short-term incentives plans. Our evidence also highlights the increasing use of peer group-adjusted measures (e.g., relative cash EPS and ROE ranking against a peer group) in determining longer-run incentives, despite the fact that members of the peer group do not measure financial performance in a directly comparable manner. Detailed case study analysis of the four major trading banks (ANZ, CBA, NAB and Westpac) shows the definition of the normalised (non-GAAP) earnings terms is not consistent among these major banks, nor does it appear to be consistently applied by individual banks over time. We also document evidence of non-GAAP earnings restatements, with around 25% of non-GAAP results subsequently being restated. These restatements are more likely to result in a downward revision of the initially reported non-GAAP result than an upward revision. We therefore conclude that existing measures of financial performance used to determine senior executive compensation are not as “objective” as might be assumed.

1. Introduction

Executive compensation has been the subject of a long history of detailed analysis and debate (Shan and Walter 2016). Recent developments within the Australian marketplace such as the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (hereafter Royal Commission) have raised very specific concerns about the extent to which compensation design can result in managerial behaviour that is inconsistent with the interests of at least some stakeholders, and which can potentially place stress on the broader financial system (Royal Commission 2019). Not surprisingly, the observations made by the Royal Commission have resulted in proposals to modify the compensation structure of senior executives of major financial institutions. One aspect of this is already reflected in the 2018 implementation of the Banking Executive Accountability Regime (BEAR), the legislation intended to impose significant deferrals on executive remuneration in approved deposit-taking institutions (ADIs), as well as facilitating the recovery of variable remuneration in the event of a failure.¹ A second, more fundamental response is reflected in the proposals released by the Australian Prudential and Regulatory Authority (APRA) to create a new Prudential Standard applicable to all APRA-regulated entities that would govern the design and oversight of remuneration arrangements. These proposals are the primary motivation for this research.

In their discussion paper, APRA (2019a) argues that there is a need to strengthen prudential requirements for remuneration across all APRA-regulated entities involved in banking, insurance and/or superannuation.² In particular, APRA argues that further regulation of remuneration arrangements is needed to ensure an appropriate alignment of interests between various stakeholders such as shareholders, customers and the broader community. Among the key reforms proposed by APRA, four stand out. First, and most directly relevant to our analysis, APRA proposes mandating that financial performance metrics must not comprise more than 50% of performance measures used for determining variable remuneration outcomes. Each individual financial performance measure must not account for more than 25% of the total. In turn, at least 50% of performance measures must be non-financial, with the suggestion of including such measures as customer outcomes, market integrity objectives and alignment with strategy and values. Second, it is APRA's intent to limit financial measures that are not risk-

¹ Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Act 2018: <https://www.legislation.gov.au/Details/C2018A00005>.

² Draft Prudential Standard CPS 511 Remuneration (APRA 2019b) promulgates heightened requirements for sound compensation principles and practices on all APRA-regulated entities' remuneration arrangements.

adjusted and directly linked to financial performance, such as share price, total shareholder return, profit, revenue, sales and other volume measures. However, they do not propose limiting the use of risk-adjusted financial measures, for example, risk-adjusted cost of funding and risk-adjusted capital adequacy. Third, a minimum deferral period for variable remuneration of up to seven years will be introduced for senior executives in larger, more complex entities. Boards will also have scope to recover remuneration for up to four years after it has vested. Finally, boards must approve and actively oversee remuneration policies for all employees, and regularly confirm they are being applied in practice to ensure individual and collective accountability.

Whether such regulation is ultimately necessary is outside the scope of our analysis.³ Rather, we focus on the proposals made by APRA that financial measures of performance should determine no more than 50% of variable remuneration (APRA 2019b, para. 38).⁴ In their place, APRA suggests measures that are viewed as reflecting the broader interests of stakeholders other than shareholders, although in many cases high levels of performance in such areas may also be of benefit to shareholders. While recognizing the inherent subjectivity of such measures (and hence, their potential abuse), APRA (2019a) maintains that the financial measures used for determining up to 50% of variable remuneration are likely significantly more objective. However, beyond some generalizations, APRA does not present evidence of how variable remuneration is actually determined (APRA 2018a; 2019a)⁵. Further, no evidence is offered to support the claim that financial measures used to determine variable pay are relatively “objective”. Our analysis directly addresses this assumption, and thereby provides evidence on how subjective performance assessment might already be, prior to the introduction of measures that are already recognized as being relatively subjective.

³ Indeed, APRA (2019a, p. 31) recognizes that “there is no clear consensus” as to the “best” mix of performance measures in determining executive compensation. However, the draft CPS 511 (APRA, 2019b) goes on to make relatively specific requirements on this issue.

⁴ APRA defines financial measures as being measures such as share price, total shareholder return, profit, revenue, sales and other volume measures. They do not include risk-adjusted measures of financial soundness that capture movements in risk-adjusted capital adequacy and risk-adjusted costs of funding.

⁵ In their discussion paper regarding remuneration practices at large financial institutions, APRA (2018a) acknowledges that performance-related remuneration metrics are directly linked to cash earnings and any adjustments made to statutory profit to calculate cash earnings may impact executive compensation. However, they mostly draw attention to the oversight role of board remuneration committee rather than the managerial subjectivity of the adjustments and performance metrics themselves.

We conduct our analysis in two stages. First, following the proposal in CPS 511 to define a new category of APRA-regulated entities, namely significant financial institutions (SFIs), we sample 11 large financial institutions to understand exactly what financial measures are typically used to determine senior executive remuneration. We are especially interested in the use of “self-defined” financial measures which do not comply with Generally Accepted Accounting Principles (GAAP). These non-GAAP measures are open to potential manipulation, due to managers’ ability to influence decisions about which items are included/excluded from non-GAAP measures. Our examination covers the years 2013-2018, and we observe that most large financial institutions use self-determined measures of financial performance (as well as ratios derived from these measures). On average, we observe that these non-GAAP measures present a better financial outcome than their closest GAAP equivalent, although this behaviour is less evident among the four largest trading banks (i.e., Australia and New Zealand Banking Group (ANZ), Commonwealth Bank (CBA), National Australia Bank (NAB) and Westpac (WBC)), relative to the other 7 significant financial institutions that we initially examine.

We also observe an increasing tendency to apply these measures on a relative basis (i.e., relative to similar measures used at other financial institutions). However, it is clear that measures reported by different financial institutions are often not calculated in a manner that is directly comparable. Hence, the use of a “comparable non-GAAP” financial measure potentially introduces a further element of measurement discretion beyond that applicable to the externally reported non-GAAP result. Whether the adjustments reflected in the non-GAAP financial measures used in remuneration design results in better or worse alignment of interests is unclear. In contrast, it is clear that there is the potential for subjectivity in many of the financial measures currently used to determine remuneration. This leads us to conclude that the determination of variable compensation in large financial institutions may already be considerably more subjective than acknowledged by APRA (2019a). The inclusion of non-financial measures of performance as advocated by APRA may further exacerbate this problem, and could lead to concerns about the overall level of subjectivity in the determination of performance-based executive pay.

In the second stage of our analysis we focus in greater detail on the four large trading banks (ANZ, CBA, NAB and WBC). We observe that short-term variable remuneration is typically assessed against non-GAAP measures such as “cash earnings”, and ratios derived from such

non-GAAP measures. In many cases, the exact derivation of these measures is not transparent, and the precise justification for their use is not adequately explained. Cash earnings is typically a measure that results from the exclusion of certain items, which are included in the statutory (i.e., GAAP) definition of profit but are deemed to be non-recurring and/or not representative of future financial performance. When long term variable pay is considered, we find that measures of cash earnings (or ratios derived therefrom) are commonly used, along with measures of total shareholder return based on share price movements and dividends.

The remainder of the paper proceeds as follows. In section two we briefly review the dilemma that arises from the use of non-GAAP financial measures to determine executive bonuses. We also present summary evidence drawn from 11 large financial institutions describing the type of non-GAAP financial performance measures used to determine both short- and long-term bonuses. We then consider the extent to which the non-GAAP measures are used for determining bonuses compared to GAAP (i.e., statutory) profit figures. In section three we extend our analysis by providing detailed descriptive evidence of the financial performance measures used by the four large trading banks to determine executive compensation. Section four concludes and highlights the lessons that can be drawn from our evidence.

2. The non-GAAP dilemma

2.1 Why non-GAAP?

In contrast to financial performance indicators measured in compliance with statutory GAAP, non-GAAP performance measures are typically determined by management and/or the board, using varying amounts of discretion (Marques 2006; Frankel et al. 2011). Because there is discretion involved in both the decision to disclose non-GAAP performance measures as well as the basis on which they are calculated (i.e., what items are excluded from the calculation of the non-GAAP measure), at least two potential reasons exist to explain their use. First, non-GAAP measures may be a mechanism by which management can better signal a firm's performance, taking account of limitations in GAAP, including the inherent conservatism found in many aspects of accounting and auditing (Barker and McGeachin 2015). On the other hand, the ability to decide whether to disclose, in addition to deciding exactly what to disclose, gives rise to concerns that such measures are likely self-serving and intended to promote a more positive view of the firm's performance than otherwise (Hoogervorst 2016).

While numerous studies have examined the determinants of the use of non-GAAP for external reporting purposes, the results are best described as mixed.⁶ While some studies have yielded evidence consistent with the explanation that non-GAAP performance measures provide useful additional information (Bhattacharya et al. 2003; Marques 2006; Entwhistle et al. 2010; Black et al. 2018), there is also evidence consistent with the self-serving explanation for the promotion and disclosure of non-GAAP measures (Bhattacharya et al. 2004; Black and Christensen 2009; Barth et al. 2012; Isidro and Marques 2013). More recently, Ribeiro et al. (2019) provide evidence that suggests that the voluntary disclosure of non-GAAP performance measures reflects the “undoing” of inherent conservatism, such that non-GAAP measures are more predictable and value-relevant than their closest statutory GAAP equivalents.

Compared to studies of externally disclosed non-GAAP measures, evidence on their use for internal management purposes (i.e., compensation awards) is less readily available. There is a very large literature that supports the linking of executive compensation to measures of financial performance so as to reduce agency costs that arise from the failure to align the interests of shareholders and management (Jensen and Meckling 1976; Bebchuk and Fried 2003). However, the use of non-GAAP measures raises concerns that managers may effectively determine the measure on which their performance is subsequently judged and rewarded. Such behaviour is clearly self-serving. Some evidence in support of this view is offered by Guest et al. (2019), who find that relatively highly paid CEOs are more likely to report non-GAAP earnings which significantly exceed their closest GAAP equivalent. They conclude that non-GAAP earnings lead boards (and investors) to be more generous with senior executives, although this conclusion is dependent on management dictating definition of non-GAAP earnings to the board. Given prior evidence (Frankel et al. 2011) that externally disclosed non-GAAP earnings are higher quality where corporate governance is stronger, we regard the ability of management in large, publicly traded financial institutions to unduly influence such measures as uncertain.

In contrast to the self-serving argument, Black et al. (2018) report that the adjustments reflected in non-GAAP earnings are decided jointly by boards and management. Further, the internal use of non-GAAP measures is associated with higher quality externally disclosed non-GAAP measures, and these are, in turn, viewed by investors as more credible. Curtis et al. (2018)

⁶ A detailed summary of extant research on non-GAAP earnings disclosures is provided by Coulton et al. (2016).

provide further support for the use of non-GAAP earnings measures to determine compensation, showing that such measures are more likely to be used as the amount of “noise” inherent in GAAP earnings increases. Hence, the extent to which the use of non-GAAP earnings measures to determine executive compensation can be viewed as “self-serving” or as “efficient” is unclear.

Sek and Taylor (2011) provide detailed evidence of non-GAAP earnings measures disclosed by the four largest Australian trading banks. They examine disclosures between 2003 and 2008, and conclude that measures reported as “cash earnings” (the most popular term) and “underlying earnings” are most commonly promoted to external stakeholders as the most appropriate measure of financial performance. They highlight inconsistencies in the way different banks treat similar items (i.e., include versus exclude), but also note that there is variation across time at each bank. Hence they conclude that there is at least some evidence to support the view that such measures may be self-serving, being neither temporally nor cross-sectionally comparable. However, Sek and Taylor only speak to external disclosures by the large trading banks and do not consider the measures used to determine executive compensation. Our evidence is directed at filling this gap.

2.2 Non-GAAP measures and compensation in significant financial institutions

In order to understand the use of non-GAAP measures as determinants of executive pay, we initially survey annual reports of a number of significant financial institutions (SFIs). Draft CPS 511 (APRA 2019a; 2019b) proposes a threshold for APRA-regulated entities to be considered as an SFI based on asset size. Authorised deposit-taking institutions with assets exceeding \$15 billion and general and life insurers with assets exceeding \$10 billion would be categorized as SFIs. We select a total of eleven SFIs, and for the years 2013-2018, we manually collect financial performance measures used to determine incentive schemes in the remuneration reports of each SFI. These eleven SFIs include banks, wealth managers and insurers. Full details of our sample SFIs are provided in Appendix 1.

We utilise text search methodology to identify all instances where self-defined measures are used to assess financial performance and whether these metrics play any role in determining cash bonus and/or share-based payments as a result of short-term and/or long-term incentive plans. As at 2018, the eleven SFIs we survey have an aggregate asset size exceeding \$4 trillion,

which represents over 80% of the total assets of financial services sector firms listed on the Australian Stock Exchange.

We begin by summarizing the types of non-GAAP performance metrics identified in the remuneration reports, as well as their frequency of use. Table 1 summarizes this evidence. Measures of financial performance described as ‘cash earnings’ are by far the most popular measure used by the SFIs we examine. There is also evidence of convergence towards this type of measure over the period we examine. However, Table 1 also highlights variation in the usage of non-GAAP measures, with measures variously described as ‘underlying profit’, ‘normalised profit’ and ‘core earnings’ also mentioned.

[Table 1 about here]

Despite the predominance of adjusted net profit after tax as a performance metric, Table 1 shows that the degree to which it is then disaggregated or related to numerous deflators (e.g., capital, equity, expense) varies significantly across institutions and time. For the years 2013 to 2018, the majority of large financial institutions use non-GAAP earnings as well as derivative ratios in their equivalent remuneration schemes. The most popular non-GAAP earnings-based ratio is adjusted ROE, followed by adjusted EPS. Other non-GAAP performance measures are risk-adjusted, taking the cost of capital and other exclusions into account, such as economic profit, profit after capital charge, and return on eligible capital. However, such adjustments are themselves relatively subjective, and therefore further add to the overall subjectivity (and scope for bias) in determining remuneration.

Over the period we examine, SFIs tend to use numerous normalised performance measures in short-term incentives. Cash bonuses are normally assessed against 2-3 self-defined performance metrics, with adjusted NPAT and derivative ratios. On the other hand, for long-term incentives, current industry practice shows that entities are more likely to use market benchmarks, such as relative and absolute total shareholder returns (TSR). Nevertheless, in recent years, there has been an increase in the number of entities utilising *relative* adjusted earnings-based ratios, measured by the internal ratio growth versus those of other financial institutions.

Given the dominance of the four large trading banks in terms of asset size and market position, we divide our sample into the four large trading banks and seven other substantial financial institutions. Table 2 reports the aggregated non-GAAP exclusions and their relative magnitude as a percentage of reported GAAP profit from 2013 to 2018. Exclusions are defined as the difference between the reported non-GAAP earnings and statutory GAAP profits, where positive exclusions reflect income-increasing adjustment. We use net profit after tax attributable to parent shareholders as our statutory measure of performance. As can be seen from Table 2, on average, the aggregate exclusions by the four large banks are about 6% of GAAP earnings, with substantially higher income-increasing exclusions in 2016 and 2017. In sharp contrast, average aggregate exclusions by the other seven SFIs are six times higher, averaging 37% of statutory earnings. The highest percentage of exclusions occurs in 2013, with an average of 61% of GAAP profit.

[Table 2 about here]

Given direct links between non-GAAP financial performance measures and executive remuneration, the natural question is whether non-GAAP earnings generally convey a more positive view of financial performance in comparison to the equivalent GAAP numbers. Table 2 provides mixed evidence on this question. For the four large trading banks, the value of aggregate non-GAAP profits fluctuates above and below the corresponding GAAP result, with no clear tendency for the non-GAAP result to exceed GAAP. However, when we consider the other seven SFIs, aggregated non-GAAP earnings consistently exceeds the GAAP equivalent. In additional analysis we observe that most of these firms report higher non-GAAP earnings than their GAAP equivalent over the six years. In other words, the tendency of reporting higher non-GAAP earnings persists among significant financial institutions in recent years.

3. Non-GAAP earnings and remuneration – a closer look

We provide further evidence on the issues associated with non-GAAP earnings and executive remuneration through a detailed case study examining the financial performance measures used by the four major Australian trading banks. All are among the largest ASX-listed firms by market capitalisation (in the S&P/ASX 20 Index) and consistently promote non-GAAP measures to external users. Furthermore, their aggregate asset size is approximately \$3.60 trillion for the financial year 2018, accounting for three-quarters of total assets of listed firms in the banking and financial services industry. By focusing on a small number of relatively

similar firms (i.e., systemically and economically important financial institutions), we are able to more carefully document how the financial performance measures are self-adjusted, and consider the extent to which they are cross-sectionally and temporally consistent.

For the years 2013-2018, we manually collect financial performance measures used to determine incentive payments as reported by ANZ, CBA, NAB and Westpac in their remuneration reports. In line with banking industry practice, each of the four have established a formal remuneration framework with an explicit linkage to strategic values and to risk and compliance outcomes. For individual banks, each framework sets a number of financial and non-financial hurdles for determining variable remuneration.⁷ We are primarily interested in the link between non-GAAP earnings reporting and executive remuneration. Therefore, we employ text search methodology to record all instances where self-defined and risk-adjusted measures have been used to determine financial performance internally and whether such measures have also been used for the purpose of external reporting. Appendix 2 contains a detailed summary of the broad terms of the method used to determine short and long-term incentive pay for each of the four major banks.

Table 3 outlines the types and the frequency of non-GAAP earnings terminology identified in the remuneration reports. Details are also given of which banks report each of the measures identified. Noticeably, in all the four major banks, non-GAAP earnings measures are utilised in assessing executive remuneration as key performance hurdles in various forms, e.g., cash NPAT, cash ROE and EPS, and other risk-adjusted measures. By construction, non-GAAP earnings are created by excluding several items from statutory profit. There is also evidence of temporal inconsistency in the items included or excluded in non-GAAP earnings across banks and over time.

We did not identify any instance of GAAP and non-GAAP earnings being used simultaneously to assess financial performance. “Cash earnings” is by far the most popular financial measure used by major banks in order to determine the short-term incentive rewards. Two direct cash

⁷ Prior to draft prudential standard CPS 511, the Australian Bankers’ Association conducted an independent review into remuneration practices in retail banking in Australia. In response to the Sedgwick review (2017), major banks have committed to implementing the recommendations such that incentives programs that were focused on recognising and rewarding sales outcomes have been changed or terminated; an appropriate balanced scorecard for bonuses; better customer-centric measures; behavioural and ethical hurdles; a rebalancing the size of variable pay relative to fixed pay.

earnings-based ratios, that is, cash EPS and cash ROE, have become common for both earnings announcements (external reporting) and remuneration determination (internal performance measurement). Together with total shareholder return, the performance hurdles for long-term incentives are mostly either cash EPS or cash ROE (direct cash earnings-based ratios) that could account for up to half of share-based payment grants.

[Table 3 about here]

Table 4 provides a comparison of the GAAP and predominant non-GAAP earnings measures for each bank over the year 2013-2018. The GAAP earnings measure used for comparison is net profit attributable to the shareholders of the parent entity. While ANZ uses two terms “underlying earnings” and “cash earnings” interchangeably, CBA and NAB report and reconcile earnings differently on a cash basis and underlying basis. CBA reports underlying earnings that fluctuate around cash earnings, but NAB reports underlying earnings that are systematically higher than both cash earnings and statutory earnings. However, both CBA and NAB do not use “underlying earnings” for determining remuneration. Westpac, on the other hand, uses “core earnings” together with “cash earnings” as performance-related metrics for the assessment of their incentive schemes. Overall, Table 4 provides mixed evidence on the extent to which non-GAAP earnings present a more favourable picture of periodic financial performance. About one third of observations reveal non-GAAP earnings (cash earnings) that are lower than the corresponding GAAP figure. In Figure we contrast statutory (GAAP) profit with the primary non-GAAP metric for each bank. In broad terms, it is clear that the pattern of movement in performance is similar, regardless of whether GAAP or non-GAAP measures are used.

[Table 4 about here]

[Figure 1 about here]

In Table 5, we provide a summary of the dominant risk-adjusted derivation from cash earnings used as a key input in determining executives’ variable rewards. We also note whether any clear explanation of the way such measures are calculated could be located. Westpac and ANZ have both utilised a broadly similar financial measure, namely “economic profit”. Westpac’s short-term incentives for CEO remuneration are weighted up to 30% on “economic profit”. CBA has used “profit after capital charge”, which typically accounts for one-quarter of short-

term incentive awards. Meanwhile, NAB's financial performance measures for the purposes of calculating the STI pool were determined by a mix of growth in cash earnings (40%), cash ROE (30%) and return on total allocated equity (30%) from FY2013 to FY2017.

It is clear from the banks' own definitions of the risk-adjusted performance measures that they are mostly derived from cash earnings, and then adjusted for the cost of capital and other deductions. However, it is noteworthy that although these risk-adjusted financial measures are self-defined, in some cases they are also relatively opaque to external users. While ANZ and Westpac provide detailed calculation and reconciliation of their measures of "economic profit", CBA and NAB do not disclose details of the calculation for their corresponding risk-adjusted measures. As an example, in 2018, eligibility for CBA's executive bonuses was assessed against a performance scorecard with a 25% weighting on cash earnings (after tax) and a 25% weighting on underlying profit after capital charge (PACC). While the cash earnings numbers were reported with reconciliation on a year-by-year basis, there appears to be no disclosure of the calculation used to determine PACC. Rather, CBA discloses that the PACC numbers are calculated "*taking into account the profit achieved, the risk to capital that was taken to achieve it, and other adjustments*". The bank itself confirms that PACC can only be comparable from the 2016 financial year onwards (i.e., not for prior years) due to methodology changes.

[Table 5 about here]

We further investigate the nature of non-GAAP exclusions in performance hurdles used to determine executive compensation. In Table 6 we list the major adjustments typically made to convert GAAP results into the non-GAAP figures. Table 7 provides a summary of the primary item-by-item normalised earnings adjustments across years. Using the categories detailed in Table 6, we classify the differences between GAAP and non-GAAP earnings for each bank in each year.

[Table 6 about here]

Over the six-year period, the most commonly excluded GAAP components are treasury share adjustments, fair value gains and losses on economic hedges, amortisation of acquired intangible assets, merger and acquisition costs, and adjustments for gains and losses from the sale of assets. These findings are in line with the existing literature documenting that merger

and acquisition expenses and gains/losses from sale of assets are the most common adjustment items in the calculation of non-GAAP earnings figures (Bhattacharya et al. 2004; Bowen et al. 2005).

[Table 7 about here]

Table 7 indicates that there are some common items for which each bank adjusts. For example, all banks adjust for gains and losses from changes in the fair value of hedges and changes in the value of Treasury share. However, each bank also includes unique adjustments. For example, Westpac excluded the \$100 million grant to establish the Westpac Bicentennial Foundation in 2014. Another instance is when Westpac bought back government guaranteed debt issues during the year ended 30 September 2013. In the statutory result, the cost incurred was recognised at the time of the buyback. In cash earnings, the cost incurred was amortised over the original term of the debt that was bought back. In general, cash earnings adjustments reflect timing difference between the statutory results and cash earnings. Appendix 2 provides further evidence on the differences between GAAP and non-GAAP earnings.

We also document the frequency and magnitude of non-GAAP earnings restatements. Out of 24 bank-year observations, there are six instances (25%) when non-GAAP earnings are restated. It is interesting to note that among the six observations, there is only one instance where the restated number is higher than the original number. The reasons for the restatement are mostly due to changes in accounting policies, the exclusions of discontinued operations, recoveries from loss on economic hedges, and reclassification of expenses. Given the fact that cash earnings numbers are mainly used by banks for determining short-term bonus payments, the higher original result (i.e., overstatement) may result in what, ex post, appears to be an overpayment of short term bonus. An example of a restatement of non-GAAP earnings is provided in Appendix 3.

Overall, our detailed analysis of the frequency and the magnitude of the use of non-GAAP earnings measures by each of the four largest Australian retailing banks yields a number of insights. First, it is clear that “cash earnings” is a key non-GAAP key performance measure used for both external reporting and internally for performance measurement. Cash earnings figures are generated by excluding certain items included in statutory profit attributable to equity holders which are deemed to be non-recurring in nature or not considered representative

of the ongoing financial and operational performance. The use of a non-GAAP performance measure both internally and externally suggests a relatively high degree of confidence by boards of directors in the integrity and reliability of such measures, albeit that restatements occur in 25% of the instances we survey.

With regard to executive remuneration, short-term incentive schemes are mostly assessed against a balanced scorecard including numerous normalised earnings measures, such as *cash earnings* and *cash earnings-based ratios* (e.g., return on equity, earnings per share) and other *risk-adjusted measures*, such as economic profit, capital adequacy, and profit after capital charge. In many cases, it is not possible to observe key assumptions in calculating these risk-adjusted measures. These measures are less likely to be used to determine long-term incentives, where share-price based measures are more common.

During our six-year sample period, two thirds (i.e., 16/24) of firm-years have non-GAAP earnings that are higher than the corresponding statutory net profit after tax. Combined with the temporal inconsistencies in the items excluded from statutory profit to calculate non-GAAP measures, there is potential for the subjectivity inherent in deciding on which items to exclude to result in upwardly biased performance measures, and higher bonus payments. However, we also observe relatively similar year-to-year variation in non-GAAP performance and GAAP results.

4. Conclusions

Recent criticism of remuneration structures within financial institutions (Royal Commission 2019) has led to APRA suggesting changes mandating limitations on the use of financial performance measures and conversely, the significant use of non-financial measures that address concerns of stakeholders such as customers and prudential regulatory concerns (APRA 2019a; 2019b). APRA is currently proposing to reduce the use of financial performance measures to no more than 50 per cent of the weighting of total performance criteria with each metric no more than 25 per cent of the total measures used. However, the mandated use of non-financial measures potentially imposes a higher degree of subjectivity on the determination of executive pay, which is somewhat ironic in light of the criticisms that have been made about both the determinants of, and the level of executive compensation. While acknowledging this concern, APRA argues that existing financial measures are relatively objective, and hence that

increased subjectivity in the overall determination of short and long-term bonuses is not problematic.

Our survey of remuneration practices in large financial institutions, and especially the four large trading banks, calls APRA's assumption into question. Overall, we document evidence of the emergence and pervasiveness of non-GAAP financial measures used in the assessment of variable remuneration among 11 significant financial institutions, with the apparent popularity of cash net profit after tax in short-term incentives plans. The increasing usage of *relative* adjusted earnings-based ratios in long-term incentives raises a further concern with regard to the comparability of non-GAAP metrics across public entities.

Further, our detailed examination of non-GAAP earnings and executive remuneration framework disclosed by the four largest Australian trading banks (i.e., ANZ, CBA, NAB and Westpac) shows performance-related remuneration measures are directly linked to cash earnings. Our evidence confirms that the definition and formation of these non-GAAP metrics are not consistent between banks, nor do they appear to be consistently applied by individual banks over time. Line-item adjustments made to statutory profit to calculate cash earnings are ultimately discretionary and therefore add to the subjectiveness of performance assessment. Whilst all the major banks use cash earnings in assessing executive remuneration, there are also additional cash earnings-based ratios and other self-defined metrics that are risk-adjusted and often considerably opaquer than the non-GAAP earnings measure that is also reported externally and hence, reconciled with the statutory measure of profit.

We also observe evidence of non-GAAP earnings restatements. During the sample period, the occurrence of restatement is around 25% of total non-GAAP reporting, including one or more line-item restatements. There is a bias in the revised items toward the initial result having been overstated, which in turn suggests that short term bonuses determined on the basis of such measures may have been over-paid.

APRA does not propose limiting the use of risk-adjusted financial measures, for example, risk-adjusted cost of funding or risk-adjusted capital adequacy. Given the fact that the risk-adjusted financial measures are typically derived from non-GAAP earnings (by deflators and other adjustments), those second-order measures lack transparency and temporal comparisons must assume a consistent basis of calculation.

Since we only present descriptive evidence, any inferences we make should be treated with caution. However, our primary purpose is to provide a comprehensive description of non-GAAP earnings metrics used in remuneration framework by a small number of relatively comparable firms, that is, the most systemically important banks and financial institutions in Australia. Our findings raise several concerns for capital market regulators. Are non-GAAP financial metrics (such as cash earnings), on average, more representative of the periodic performance for remuneration purpose? Or should firms include statutory NPAT in remuneration framework as it is a more comparable and transparent measure of financial performance across time? Would it be better if firms use both non-GAAP and GAAP financial measures simultaneously? Or at least, should firms disclose normalised earnings, as a performance hurdle, together with the corresponding statutory earnings in remuneration report so that stakeholders can be better informed?

The rise of non-GAAP reporting and the use of such metrics in executive compensation highlights concerns related to the transparent reporting of financial performance, as well as the role of financial performance in determining executive compensation. Regardless of what the optimal mix might be of financial and non-financial measures, it is apparent that extant financial measures used to determine short term bonuses and some longer-term rewards are arguably far more subjective than some might assume. Whether such subjectivity should cause those advocating the mandatory use of even more subjective performance measures to pause for reflection is a question worth considering for market regulators in the process of enhancing the bank executive accountability regime.

References

- Australian Prudential Regulation Authority, 2018a. *Remuneration practices at large financial institutions*. Information paper, April.
- Australian Prudential Regulation Authority, 2018b. *Implementing the Banking Executive Accountability Regime*. Information paper, 17 October.
- Australian Prudential Regulation Authority, 2019a. *Strengthening prudential requirements for remuneration*. Discussion paper, 23 July.
- Australian Prudential Regulation Authority, 2019b. *Prudential Standard CPS 511 Remuneration*. Draft version, July.
- Barker, R. and McGeachin, A., 2015. An analysis of concepts and evidence on the question of whether IFRS should be conservative. *Abacus*, 51(2), pp.169-207.
- Barth, M.E., Gow, I.D. and Taylor, D.J., 2012. Why do pro forma and street earnings not reflect changes in GAAP? Evidence from SFAS 123R. *Review of Accounting Studies*, 17(3), pp.526-562.
- Bebchuk, L.A. and Fried, J.M., 2003. Executive compensation as an agency problem. *Journal of Economic Perspectives*, 17(3), pp.71-92.
- Bhattacharya, N., Black, E.L., Christensen, T.E. and Larson, C.R., 2003. Assessing the relative informativeness and permanence of pro forma earnings and GAAP operating earnings. *Journal of Accounting and Economics*, 36(1-3), pp.285-319.
- Bhattacharya, N., Black, E.L., Christensen, T.E. and Mergenthaler, R.D., 2004. Empirical evidence on recent trends in pro forma reporting. *Accounting Horizons*, 18(1), pp.27-43.
- Black, D.E. and Christensen, T.E., 2009. US managers' use of 'pro forma' adjustments to meet strategic earnings targets. *Journal of Business Finance & Accounting*, 36(3-4), pp.297-326.
- Black, D.E., Christensen, T.E., Ciesielski, J.T. and Whipple, B.C., 2018. Non-GAAP reporting: Evidence from academia and current practice. *Journal of Business Finance & Accounting*, 45(3-4), pp.259-294.
- Bowen, R.M., Davis, A.K. and Matsumoto, D.A., 2005. Emphasis on pro forma versus GAAP earnings in quarterly press releases: Determinants, SEC intervention, and market reactions. *The Accounting Review*, 80(4), pp.1011-1038.
- Coulton, J., Ribeiro, A., Shan, Y. and Taylor, S., 2016. The rise and rise of non-GAAP disclosure: A survey of Australian practice and its implications. Chartered Accountants Australia and New Zealand, Sydney.
- Curtis, A., Li, V. and Patrick, P.H., 2018. The use of adjusted earnings in performance evaluation. Available at SSRN 2682652.

- Entwistle, G.M., Feltham, G.D. and Mbagwu, C., 2010. The value relevance of alternative earnings measures: a comparison of pro forma, GAAP, and I/B/E/S earnings. *Journal of Accounting, Auditing & Finance*, 25(2), pp.261-288.
- Frankel, R., McVay, S. and Soliman, M., 2011. Non-GAAP earnings and board independence. *Review of Accounting Studies*, 16(4), pp.719-744.
- Guest, N.M., Kothari, S.P. and Pozen, R., 2019. High non-GAAP earnings predict abnormally high CEO pay. *Available at SSRN 3030953*.
- Hoogervorst, H., 2016. Performance reporting and the pitfalls of non-GAAP metrics. European Accounting Association Conference, Maastricht.
- Isidro, H. and Marques, A., 2013. The effects of compensation and board quality on non-GAAP disclosures in Europe. *The International Journal of Accounting*, 48(3), pp.289-317.
- Jensen, M.C. and Meckling, W.H., 1976. Theory of the firm: Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics*, 3(4), pp.305-360.
- Marques, A., 2006. SEC interventions and the frequency and usefulness of non-GAAP financial measures. *Review of Accounting Studies*, 11(4), pp.549-574.
- Ribeiro, A., Shan, Y. and Taylor, S., 2019. Non-GAAP Earnings and the Earnings Quality Trade-off. *Abacus*, 55(1), pp.6-41.
- Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, 2019. *Final report*. Commonwealth of Australia, Canberra.
- Sedgwick, S., 2017. *Retail banking remuneration review*. Issues paper, 17 January.
- Sek, J. and Taylor, S., 2011. Profit or Prophet? A Case Study of the Reporting of Non-GAAP Earnings by Australian Banks. *Australian Accounting Review*, 21(4), pp.327-339.
- Shan, Y. and Walter, T., 2016. Towards a set of design principles for executive compensation contracts. *Abacus*, 52(4), pp.619-684.

Figure 1: Comparison of primary non-GAAP financial measures and GAAP equivalents

This figure contrasts the magnitude of each bank's 'cash earnings' with their corresponding GAAP earnings figure.



Table 1: The frequency of significant financial institutions (SFIs) using non-GAAP financial measures in remuneration

The table presents the types and the frequency of non-GAAP performance measures identified in SFIs' remuneration reports. The sample consists of 66 firm-year observations over 2013-2018, with 11 large financial institutions. Details of SFIs can be found in Appendix 1.

Financial measures	2013	2014	2015	2016	2017	2018
Panel A: Short-term incentive plans						
Cash/underlying/normalised net profit after tax	7	7	9	9	9	10
Cash/underlying/normalised net profit before tax	1	1	1	1	1	1
<i>Ratios</i>						
Cash/underlying/normalised earnings per share	3	3	4	4	2	2
Cash/underlying/normalised return on equity	6	6	6	7	8	7
Cash/underlying/normalised cost to income ratio	3	3	4	4	3	3
<i>Other non-GAAP performance measures</i>						
(Underlying) Economic profit	2	2	2	2	2	2
(Underlying) Profit after capital charge	2	2	2	2	2	2
Risk-adjusted return on eligible capital	2	1	2	2	1	2
Panel B: Long-term incentive plans						
Cash/underlying/normalised earnings per share	2	2	3	3	2	2
Cash/underlying/normalised return on equity	2	2	2	3	4	4

Table 2: Comparison of the median value of GAAP and non-GAAP earnings by year

The table presents the aggregated GAAP and the predominant non-GAAP earnings over 2013-2018 for two groups: the four large trading banks (ANZ, CBA, NAB and Westpac) and other seven large financial institutions. It also shows the aggregate exclusions, defined as the difference between non-GAAP earnings and GAAP profits, and their relative magnitude as a percentage of statutory profit across these two groups over the examined period.

\$ Million	2013	2014	2015	2016	2017	2018	Average
Big 4 Banks							
GAAP profit	26,217	28,758	30,906	22,733	29,609	29,378	
Non-GAAP profit	27,350	28,609	30,012	29,644	31,523	28,984	
Exclusions	1,133	-149	-894	6,911	1,914	-394	1,420
Exclusions/Statutory profit	4.3%	-0.5%	-2.9%	30.4%	6.5%	-1.3%	6.1%
Other SFIs							
GAAP profit	2,640	4,562	4,561	3,244	2,783	3,494	
Non-GAAP profit	4,249	5,488	5,314	4,501	4,098	4,750	
Exclusions	1,610	926	754	1,257	1,316	1,257	1,186
Exclusions/Statutory profit	61.0%	20.3%	16.5%	38.7%	47.3%	36.0%	36.6%

Table 3: Non-GAAP financial performance measures used in remuneration by bank and year

The table presents the types and the frequency of non-GAAP earnings terminology identified in the remuneration reports of the four largest trading banks between 2013 and 2018. Details are also given of which banks report each of the measures identified.

Financial measures	2013	2014	2015	2016	2017	2018
Panel A: Short-term incentive plans						
Cash earnings/profit after tax	CBA NAB ANZ	CBA NAB ANZ	CBA NAB ANZ	CBA NAB ANZ	CBA NAB ANZ	CBA NAB* ANZ
Core earnings			WBC	WBC	WBC	WBC
Ratios						
Cash earnings per share	ANZ	ANZ	ANZ	ANZ		
Cash return on equity	ANZ NAB WBC	ANZ NAB WBC	ANZ NAB WBC	ANZ NAB WBC	ANZ NAB	ANZ NAB
Other non-GAAP performance measures						
(Underlying) Economic profit	ANZ WBC	ANZ WBC	ANZ WBC	ANZ WBC	ANZ WBC	ANZ WBC
(Underlying) Profit after capital charge	CBA	CBA	CBA	CBA	CBA	CBA
Return on total allocated equity	NAB	NAB	NAB	NAB	NAB	NAB
Panel B: Long-term incentive plans						
Cash earnings/profit after tax						NAB
Ratios						
Cash earnings per share	WBC	WBC	WBC	WBC		
Cash return on equity				NAB	NAB WBC	NAB WBC
Return on total allocated equity						NAB

* In FY2018, NAB simplified the remuneration framework by using the same performance criteria for both short-term and long-term variable rewards.

Table 4: Terminology and comparison of GAAP and non-GAAP earnings by bank and year

The table presents a summary of the GAAP and predominant non-GAAP earnings measures for each of the four large trading banks from 2013-2018.

	Earnings type (\$m)	2013	2014	2015	2016	2017	2018
ANZ	Statutory profit	6,272	7,271	7,493	5,709	6,406	6,400
	Underlying/cash earnings	6,498	7,117	7,216	5,889	6,938	5,805
CBA	Statutory profit	7,677	8,631	9,063	9,227	9,928	9,329
	Cash earnings	7,819	8,680	9,137	9,450	9,881	9,412
	Underlying profit	7,714	8,483	8,987	9,350	9,837	9,223
NAB	Statutory profit	5,452	5,295	6,338	352	5,285	5,554
	Cash earnings	5,936	5,184	5,839	6,483	6,642	5,702
	Underlying profit	10,406	8,733	9,399	9,995	10,260	8,985
WBC	Statutory profit	6,816	7,561	8,012	7,445	7,990	8,095
	Cash earnings	7,097	7,628	7,820	7,822	8,062	8,065
	Core earnings	11,123	11,574	11,905	12,305	12,451	12,365

Statutory profit is net profit attributable to the parent entity shareholders. ANZ uses two terms “cash earnings” and “underlying earnings” interchangeably. CBA and NAB reports “cash earnings” and “underlying earnings” on different bases. WBC uses two different terms “cash earnings” and “core earnings”. All disclose the adjusted earnings outcomes in both earnings announcements and annual reports.

Table 5: Terminology and definition of risk-adjusted financial performance measures

The table presents that the terminology and definition risk-based performance measures used by Australia's four largest trading banks from 2013-2018.

	Risk-adjusted performance measures	Definition	Outcomes ¹	Calculation ²
ANZ	Economic profit	Economic profit is an unaudited risk adjusted profit measure determined by adjusting <u>cash profit</u> for economic credit costs, the benefit of imputation credits and the cost of capital.	Yes	Yes
CBA	Profit after capital charge	The Group uses PACC, a risk-adjusted measure, as a key measure of financial performance. It takes into account the profit achieved, the risk to capital that was taken to achieve it, and other adjustments.	Yes ³	No
NAB	Return on total allocated equity	ROTAE is a function of <u>cash earnings</u> , Risk Weighted Assets, regulatory capital deductions and target capital ratios.	Yes ⁴	No
WBC	Economic profit	Economic profit represents the excess of adjusted <u>Cash Earnings</u> over a minimum required rate of return on equity invested. For this purpose, adjusted Cash Earnings is defined as Cash Earnings plus the estimated value of franking credits paid to shareholders.	Yes	Yes

1. Risk-adjusted metrics have been normally disclosed in Appendix 4E and Annual Reports.
2. The calculation of risk-adjusted metrics, if provided, is described in details only in Appendix 4E.
3. Due to methodology changes, comparatives for PACC have only been available since FY2016.
4. The ROTAЕ outcomes have not been provided until FY2017.

Table 6: Summary of non-GAAP earnings adjustments

The table provides a summary of non-GAAP earnings adjustments by Australia's four largest trading banks from 2013-2018.

Abbreviation	Adjustment item
AMORT	Amortisation of acquired intangible assets (other than goodwill)
BUYBACK	Buyback of government guaranteed debt
CHARITY	Grant for charitable purpose
DIST	Distributions on other equity instruments (other than ordinary equity)
HEDGE	Gains/losses from fair value movements in economic hedges
LOSS	Net loss attributable to discontinued operations
MERGE	Merger and acquisition costs
PROV	Special provisions e.g. for new business initiatives
RESTATE	Adjustments resulting from changes in accounting principles/restatements
SALE	Sale of business units/assets
SETTLE	Gains/losses on settlement of legal claims/lawsuits
TREASURY	Adjustment for changes in the value of Treasury shares
VALUE	Adjustment for changes in the value of life/wealth management companies owned by the bank
WRITEDOWN	Write-down of impaired assets, such as capitalised technology cost

Table 7: Composition of non-GAAP earnings adjustments by bank and year

The table presents a summary of the item-by-item normalised earnings adjustments by Australia's four largest trading banks from 2013-2018.

	2013	2014	2015	2016	2017	2018
ANZ	TREASURY	TREASURY	TREASURY	TREASURY	TREASURY	TREASURY
	HEDGE (3)					
	VALUE	VALUE	VALUE	VALUE	VALUE	VALUE
					SALE	SALE
CBA	TREASURY	TREASURY	TREASURY	TREASURY	TREASURY	TREASURY
	HEDGE	HEDGE	HEDGE	HEDGE	HEDGE	HEDGE
	MERGE	MERGE	MERGE	MERGE	MERGE	MERGE
	SETTLE	SETTLE	RESTATE	RESTATE		SALE
		SALE				
NAB	TREASURY	TREASURY	TREASURY	TREASURY		
	HEDGE	HEDGE	HEDGE	HEDGE	HEDGE	HEDGE
	AMORT	AMORT	AMORT	AMORT	AMORT	AMORT
	DIST	DIST	DIST	DIST	DIST	DIST
	VALUE	VALUE	VALUE	VALUE	LOSS	SALE
	PROV	RESTATE	SALE	LOSS		LOSS
	SETTLE		LOSS			
	RESTATE	RESTATE				
WBC	TREASURY	TREASURY	TREASURY	TREASURY	TREASURY	TREASURY
	HEDGE (3)	HEDGE (2)				
	AMORT	AMORT	AMORT	AMORT	AMORT	AMORT
	MERGE	MERGE (2)	MERGE (2)	MERGE	SALE	SALE
	BUYBACK	BUYBACK	BUYBACK			
	RESTATE	SETTLE	SALE			
		PROV	PROV			
	CHARITY	WRITEDOWN				

Appendix 1. Significant financial institutions (SFIs)

The table shows the list of eleven significant financial institutions publicly listed on ASX, their corresponding total assets and their use of non-GAAP performance measures in remuneration.

ASX Code	Company Name	GICS	Industry Group	Asset size ¹	NG in STI ²	NG in LTI ²
CBA	Commonwealth Bank of Australia	4010	Banks	975,165,000,000	Yes	No
ANZ	Australia & New Zealand Banking Group	4010	Banks	942,624,000,000	Yes	No
WBC	Westpac Banking Corporation	4010	Banks	879,592,000,000	Yes	Yes
NAB	National Australia Bank	4010	Banks	806,510,000,000	Yes	Yes
AMP	AMP Limited	4020	Diversified Financials	145,278,000,000	Yes	Yes
SUN	Suncorp Group	4030	Insurance	99,333,000,000	Yes	No
BEN	Bendigo and Adelaide Bank	4010	Banks	71,439,800,000	Yes	Yes
QBE	QBE Insurance Group	4030	Insurance	56,081,042,788	Yes	Yes
BOQ	Bank of Queensland	4010	Banks	52,980,000,000	Yes	Yes
IAG	Insurance Australia Group	4030	Insurance	29,766,000,000	Yes	Yes
CGF	Challenger Limited	4020	Diversified Financials	25,300,500,000	Yes	No

1. Total assets for the financial year ended 2018.
2. The use of non-GAAP performance metrics in short-term incentives and long-term incentives in any year over the examined period 2013-2018, respectively.

Appendix 2. Summary of remuneration frameworks for the four large trading banks

Commonwealth Bank (CBA)

CBA's remuneration framework has a mixture of a fixed component, short-term and long-term variable remuneration, each of which targets for one third of the total executive remuneration. Both STI and LTI are measured against financial and non-financial metrics. In particular, financial metrics in STI are primarily 'cash earnings' and underlying 'profit after capital charge'.

Prior to 2016, CBA had a very ambiguous disclosure related to the financial metrics used in STI. The Group used *Profit after Capital Charge* (PACC), a risk-adjusted measure, as one of the key measures of financial performance without detailed description related to the weighting, the calculation and the reconciliation of the key input. Because of the weaknesses in the Bank's remuneration systems, CBA faced a historic 'first strike' on the remuneration report in 2016. The main reason for the votes against the adoption of the remuneration report was due to the lack of clear targets and performance metrics in the report.

Summary of CBA's financial measures in the remuneration framework

	FY2017	FY2018
<i>Short-term variable remuneration</i>		
Weighting to financial measures	CEO - 40%	CEO - 60%
	Business unit Executives - 45%	Business unit Executives - 60%
	Support function Executives - 25%	Support function Executives - 40%
	CRO - 25%	CRO - 30%
Key financial measures	Cash NPAT	Cash NPAT - 25%
	Underlying PACC	Underlying PACC - 25%
	Productivity	Productivity - 10%
<i>Long-term variable remuneration</i>		
Performance measures	Relative TSR - 75%	Relative TSR - 75%
	Relative customer satisfaction - 25%	Trust and reputation measure - 12.5%
		Employee engagement measure - 12.5%

Subsequently, CBA have committed to support the Australian Bankers' Association Better Banking initiatives and to implementing the recommendations from Sedgwick review. In the Remuneration Report FY2017, CBA indicated clearly the terms of key financial measures, inclusive of cash NPAT, underlying PACC and productivity. The Remuneration Report FY2018 marked the first time CBA has provided the weighting of each financial measures in the remuneration report, including cash NPAT (25%), underlying PACC (25%) and productivity (10%). Nevertheless, there has not been a genuine calculation and reconciliation for the key risk-adjusted measure PACC disclosed by the Bank.

Westpac Group (WBC)

Executive total reward framework is split between three core components:

- *Fixed remuneration* – takes into account the size and complexity of the individual responsibilities, skills and disclosed pay levels within the financial services industry.
- *Short-term incentive (STI)* – is determined based on an STI target set. Performance is measured against risk-adjusted financial targets and non-financial targets that support the Group’s short and long-term strategy.
- *Long-term incentive (LTI)* – is designed to retain executives and to align their performance with the long-term interests of shareholders. The amount of the award takes into account market benchmarks and individual performance over time.

Summary of WBC’s financial measures in the remuneration framework

	Up until FY2016	FY2017	FY2018
<i>Short-term incentives</i>			
Weighting to financial measures ¹	CEO - 40% Senior Executives - 45% CRO - 30%	CEO - 40%	CEO - 40%
Key financial measures	Economic profit and Cash ROE - 30% Core earnings - 10%	Economic profit - 30% Core earnings - 10%	Economic performance - 40% including: - Economic profit - Core earnings - Operating expense
<i>Long-term incentives</i>			
Performance measures	Relative TSR - 50% Cash EPS - 50%	Relative TSR - 50% Cash ROE - 50%	Relative TSR - 50% Cash ROE - 50%

1. Individual measures differ for each Group Executives. Westpac did not provide the weighting to financial measures and non-financial measures for Group Executives other than CEO in FY2017-2018.

The primary financial indicator used for STI is economic profit, which measures ‘cash earnings’ adjusted for the cost of capital. Group economic profit, core earnings growth and cash ROE accounted for 40% of the CEO’s scoreboard up until FY2016. Besides, LTI was granted on the basis of two performance hurdles Relative TSR (50%) and cash EPS (50%).

In FY2017, the Board has decided that the growth based cash EPS LTI hurdle was no longer the appropriate hurdle alongside the TSR hurdle for assessing the Group’s long-term performance. Accordingly, the Board has determined to replace the cash EPS LTI hurdle with the cash ROE performance hurdle for LTI awards commencing in 2017.

It is safely concluded that Westpac short-term and long-term incentive schemes are heavily dependent on the outcomes of non-GAAP performance measures and risk-adjusted financial targets.

Australia and New Zealand Banking Group (ANZ)

Similar to Westpac, ANZ uses Economic Profit as a key input in determining the short-term variable remuneration. However, for long-term variable remuneration, the Bank utilises wholly market benchmarks, i.e., relative and absolute total shareholder return (TSR) hurdles.

Summary of ANZ's financial measures in the remuneration framework

	Up until FY2016	FY2017-2018
<i>Short-term incentives</i>		
Weighting to financial measures		CEO - 50% Group Executives - 50%
Key financial measures	Economic profit Revenue Cash ROE Cash EPS	Economic profit Operating expenses Cash ROE Relative TSR
<i>Long-term incentives</i>		
Performance measures	Relative TSR - 75% Absolute TSR - 25%	Relative TSR - 75% Absolute TSR - 25%

Up until FY2016, ANZ used a balanced scorecard approach to measure performance in relation to the Group's main variable remuneration plans. Even though the Bank attempted to include a number of financial and non-financial metrics in the executive performance scorecard, the remuneration framework appeared to lack the certain degree of transparency, especially in terms of financial measures. ANZ used four key financial metrics: revenue, economic profit, cash ROE, cash EPS without specifying their relative importance or the weighting for each measure.

Starting from FY2017, the Bank disclosed the weighting for group performance measurement as follows:

- Financial and Discipline (50% weighting);
- Customer (30% weighting);
- People and Reputation (20% weighting).

The Bank has made an effort to disclose the actual performance outcomes of the financial metrics; however, ANZ has not provided the weighting of each financial measure used in determining executive compensation.

National Australia Bank (NAB)

NAB's total reward consists of:

- *Fixed remuneration* – provided as cash and benefits;
- *Short-term incentive* (STI) – reflecting both individual and business performance for the current year that support the longer term objectives of the Group; and
- *Long-term incentive* (LTI) – provided to drive management decisions focussed on the long-term prosperity of the Group through the use of relative performance hurdles.

Prior to FY2018, the Board used cash earnings (40%), cash ROE (30%) and Return on Total Allocated Equity (ROTAE) (30%) to determine the STI pool for executive remuneration.

Then, individual senior executive performance is assessed against three key measures supporting the Group's strategy and business objectives:

- Group cash earnings – 33%
- Cash ROE – 33%
- Net promoter score (NPS), scoring customer outcomes – 33%

Summary of NAB's financial measures in the remuneration framework

	FY2015	FY2016	FY2017
<i>Short-term incentive</i>			
Weighting to financial measures	CEO - 66% Senior Executives - 66%	CEO - 66% Senior Executives - 66%	CEO - 25% Senior Executives - 25%
Key financial measures	Cash earnings - 33% Cash ROE - 33%	Cash earnings - 33% Cash ROE - 33%	Cash earnings Cash ROE Revenue and Expenses
<i>Long-term incentive</i>			
Performance measures	Relative TSR - 100% -Against two peer groups: ASX Top 50 and Top Financial Services firms	Relative TSR - 50% Relative Cash ROE - 50%	Relative TSR - 50% Relative Cash ROE - 50%

In FY2016, the Bank utilised a new performance hurdle in LTI: *relative cash ROE*, measured by cash ROE growth versus the other banks, in replacement for the previous Top Financial Services TSR hurdle. However, cash ROE itself is of *ad hoc* and idiosyncratic nature, thus, this has the obvious effect of limiting cross-sectional comparability of cash ROE across banks.

In FY2018, the Bank pioneered to promulgate a new executive remuneration framework which is simplified by using the same performance measures for variable rewards regardless of cash bonuses or share-based payments.

Each Executive's VR outcome for a financial year is determined in accordance with the following formula. The formula considers both the Group's performance and the Executive's individual performance over the financial year along with the Executive's target VR opportunity:

$$\text{The Executive's target VR opportunity (\$)} \times \text{The Executive's individual score (which reflects the Executive's performance over the financial year)} \times \text{One NAB Score (which reflects the Group's performance over the financial year)}$$

An Executive's actual VR outcome can be higher or lower than their target VR opportunity, but will not exceed their maximum VR opportunity, and will depend on the Executive's individual score and the One NAB Score for the financial year, both of which are determined by the Board.

Summary of NAB's variable remuneration framework in FY2018

Group Performance		Individual Performance	
Measure	Weighting	Measure	Weighting
<i>Financials</i>		<i>Financials</i>	20%
Cash earnings	25%	<i>Non-financials</i>	80%
Cash ROE	25%	Customer outcomes	
ROTAE	25%	Risk	
<i>Non-financials</i>		People management	
Transformation	25%	Strategy	

In short, even with the previous remuneration schemes or the new simpler variable remuneration approach, major financial measures are normalised (non-GAAP) earnings, normalised earnings-based ratios and risk-adjusted measures.

Appendix 3. Non-GAAP Earnings Restatement Example

Example of a restatement from National Australia Bank Financial Report from 2013 - 2016

NAB Financial Report 2013, Note 2 Segment Information, p. 89 (original number)

	Group	
	2013 \$m	2012 \$m
Cash earnings		
Group cash earnings ⁽¹⁾	5,936	5,433
Non-cash earnings items (after tax):		
Distributions	188	207
Treasury shares	(342)	(155)
Fair value and hedge ineffectiveness	(151)	(270)
IoRE discount rate variation	22	16
Hedging costs on SCDO assets	-	(99)
Litigation expense/recovery	39	(101)
Amortisation of acquired intangible assets	(77)	(99)
PPI and customer redress provisions	(163)	(239)
Impairment of goodwill and software	-	(349)
Restructure Costs	-	(174)
Due diligence, acquisition and integration costs	-	(88)
Net profit attributable to owners of the Company	5,452	4,082

⁽¹⁾ Includes eliminations and distributions.

NAB Financial Report 2014, Note 2 Segment Information, p. 98 (original number for cash earnings 2014 and restated number for cash earnings 2013)

	Group	
	2014 \$m	2013 ⁽¹⁾ \$m
Cash earnings		
Group cash earnings ⁽²⁾	5,184	5,747
Non-cash earnings items (after tax):		
Distributions	180	188
Treasury shares	(43)	(413)
Fair value and hedge ineffectiveness	83	(151)
DAC discount rate variation	(20)	22
Litigation expense/recovery	-	39
Amortisation of acquired intangible assets	(89)	(77)
Net profit attributable to owners of the Company	5,295	5,355

⁽¹⁾ Restated to include Payment Protection Insurance provision charges in operating expenses for cash earnings purposes and for the impact of adopting new accounting standards as detailed in Note 1 'Principal accounting policies' on page 81.

⁽²⁾ Includes eliminations and distributions.

NAB Financial Report 2015, Note 2 Segment Information, p. 101 (original number for cash earnings 2015 and restated number for cash earnings 2014)

	Group	
	2015 ⁽¹⁾ \$m	2014 ⁽¹⁾ \$m
Cash earnings		
Group cash earnings ⁽²⁾	5,839	5,055
Non-cash earnings items (after tax):		
Distributions	175	180
Treasury shares	4	(43)
Fair value and hedge ineffectiveness	497	83
Life insurance economic assumption variation	13	(20)
Amortisation of acquired intangible assets	(94)	(74)
Sale and demerger transaction costs	(77)	-
Net profit / loss attributable to discontinued operations ⁽³⁾	(19)	114
Net profit attributable to owners of NAB	6,338	5,295

⁽¹⁾ Information is presented on a continuing operations basis including prior period restatements.

⁽²⁾ Includes eliminations and distributions.

⁽³⁾ Included within discontinued operations are the post-tax profit / loss of of GWB and the post-tax gain / loss recognised on the disposal of the assets relating to GWB. Refer to Note 51 - Discontinued operations for further details.

NAB Financial Report 2016, Note 2 Segment Information, p. 75 (restated number for cash earnings 2015)

	Group	
	2016 ⁽¹⁾ \$m	2015 ⁽¹⁾ \$m
Cash earnings		
Group cash earnings ⁽²⁾	6,483	6,222
Non-cash earnings items (after tax):		
Distributions	124	175
Treasury shares	61	4
Fair value and hedge ineffectiveness	(126)	516
Life insurance 20% share of profit	(39)	(37)
Amortisation of acquired intangible assets	(83)	(80)
Net (loss) attributable to discontinued operations	(6,068)	(462)
Net profit attributable to owners of NAB	352	6,338

⁽¹⁾ Information is presented on a continuing operations basis including prior period restatements.

⁽²⁾ Includes eliminations and distributions.

NAB restated non-GAAP earnings numbers between 2013 and 2015. Except in 2013, the Bank restated both GAAP and non-GAAP earnings, in the other years, the Bank only restated normalised cash earnings due to revision of one or several non-cash earnings line items. After 2015, the Bank has added one cash-earnings adjustment 'Net loss attributable to discontinued operations' to be excluded from statutory profit.