GRG Remuneration Review

Use of LTI Plans Reducing?

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INTRODUCTION

A comment that is currently circulating is that companies are moving out of long term incentive (LTI) plans and into larger short term incentive (STI) plans. Our experience is that this statement is generally not true in relation to top executive roles but there is some substance in relation to lower level executives.

This article seeks to canvas various aspects of this topic with a view to helping companies develop future remuneration strategies that are appropriate to their circumstances, market competitive, cost effect, are consistent with good corporate governance and recognise the views of significant stakeholders.

CATALYST FOR CHANGE

The main catalyst for change has been the accounting standard covering share-based payments. It requires the value of equity based LTI plans to be expensed in company profit and loss accounts. That value is then disclosed as part of executive remuneration in Remuneration Reports.

Prior to the release of AASB 2 (Share-based Payment accounting standard) many Boards had come to the view that the cost of LTI plans ought to be reflected in company accounts. However, it would appear that they were not fully prepared for the impact of AASB 2 in that:

1. The accounting charge does not qualify as a taxation deduction for the company and therefore goes straight to the bottom line in terms of its impact on reported profitability. Therefore, relative to an equal cost of another tax deductible remuneration expense, the equity based LTI would appear to be more expensive.
2. The accounting charge can remain an expense even though none of the LTI equity units actually vest. This applies when market conditions apply to vesting of the LTI equity units. Note that total shareholder return (TSR) is the most widely used vesting condition and it is a market condition.
3. The accounting expense can bear no relationship to the benefit actually received by the executive. For example, options can vest and the accounting charge is expensed by the company but there may be no benefit to executives because the exercise price exceeds the market value of a share.

Each of these aspects is discussed below.

GRG Remuneration Reviews are articles to assist directors and senior executives who have responsibilities in relation to Board and senior executive remuneration and other human resources issues. Their role varies between articles with some aimed at stimulating critical thinking, others updating information and others simply acting as a reminder of principles and approaches where awareness may need to be heightened.

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TAX DEDUCTIBILITY

In the case of share and right plans, a tax deduction may be simply generated provided certain conditions are satisfied and the shares are purchased. In the case of share plans it is usual for the shares to be acquired and in many cases held by a trustee for the benefit of the LTI plan participants. Funding of the trust is via non-refundable contributions made by the company to the trustee which then purchases the shares usually at market value via market purchase or subscription to a new issue.

The same approach can apply to rights plans except that funding and purchase takes place when the rights have vested and are exercised.

The funds contributed by the company to the trustee do qualify as an income tax deduction for the company provided that certain simple conditions are satisfied.

It should be noted that the tax deduction is not limited to the accounting charge and, in the case of rights, would generally exceed the accounting charge. For example, a 3 year vesting right to a share which has a 5% dividend yield would typically have a value of approximately 85% of the share price when the right is granted e.g. share price $10.00 and right value of $8.50. If the share price had rises to say $12.00 when the right is exercised then the contribution and tax deduction would be $12.00 some 41% higher than the value of the right.

Given that the dominant form of LTI plan is a rights plan and that a tax deduction can be simply generated, it follows that lack of tax deductibility of the accounting charge should not remain an ongoing source of concern for companies.

LACK OF CORRELATION BETWEEN ACCOUNTING CHARGE AND VESTING

The lack of correlation between the accounting charge and vesting arises when market related vesting conditions are used. When a market related vesting condition is attached to a LTI equity unit (share, right or option), the value of the equity unit must take account of the vesting condition which should result in the value being discounted. It appears from annual reports that discounts for vesting conditions are often small (less than say a 30% discount) when market related vesting conditions apply. This small discount means that high vesting (say more than 70%) needs to be achieved for there to be reasonable correlation between the accounting charge and the number of equity units that vest.

Even though institutional investors tend to favour TSR as the vesting condition the accounting treatment of equity unit grants would lead to the conclusion that TSR should only be used when there is a strong expectation that high vesting will be achieved as this is when a good correlation will exist between the accounting charge and vesting.

In other circumstances consideration could be given to using a non-market vesting condition such as economic profit growth, EPS growth or service. When these are used the accounting charge is directly related to vesting.

ACCOUNTING CHARGE DOES NOT EQUAL EXECUTIVE BENEFIT

Among sophisticated investors the difference between the accounting charge disclosed as remuneration and the benefits received by individual executive would be well understood. Among top executives this difference should also be well understood.

That some others who may read annual reports do not fully appreciate the difference would not in the author’s view warrant changing a company’s approach to remuneration of top executives.

WHERE IS CHANGE OCCURING

Our experience in dealing with ASX listed companies is that the accounting charge has lead to a critical review of who should participate in LTI plans. Prior to the accounting charge being introduced there had been a tendency for companies to extend participation in LTI plans down to levels of executives and management where they have little or no impact on long term performance as their planning horizon is often less than 12 month ahead. Their participation in LTI plans was aimed at enabling them to acquire equity stakes in their companies and to improve stability due to the retention impact of LTI plans.

When seeking to restrict participation on LTI plans to executives with longer term planning horizons companies have been recognising that the reasons for previously including lower level executives and managers in LTI plans remain relevant. Further, to not replace the LTI with another remuneration component would result in a reduction in remuneration levels. In these circumstances, some companies have replaced making offers under the LTI plan with deferred shares or rights which match short term incentive (STI) plan cash payments.

Deferred shares and rights are those which qualify for tax deferral and vest between 1 and 5 years (mainly 2 or 3 years) after they are granted. Vesting is related to continued service with the company. The accounting charge only arises for those shares or rights that vest as service is not a market vesting condition.

LTI PLANS CONTINUE FOR TOP EXECUTIVES

The data in the following table has been extracted for the GRG 2008 Top Executive Remuneration Review and shows that LTIs continue to be a significant component of top executive remuneration. This data relates to the 2006-07 year when the Australian economy was booming and STI payouts were generally higher than normally expected. Unlike STI payouts, LTI remuneration values are independent of performance. Thus, the relationships between STI and LTI in the following table would tend to over emphasise STI relative to LTI.

Role	STI – P50 as % of Base Package					LTI – P50 as % of Base Package				
	$500m to $1b	$1b to $2b	$2b to $5b	$5b to $10b	>$10b	$500m to $1b	$1b to $2b	$2b to $5b	$5b to $10b	>$10b
CEO	26%	36%	59%	75%	74%	14%	33%	61%	53%	85%
CFO	19%	26%	47%	57%	81%	15%	28%	34%	29%	62%
GM	16%	22%	39%	43%	82%	8%	19%	27%	21%	68%
Co Sec	18%	19%	40%	33%	55%	14%	16%	29%	29%	43%

WHY ARE LTI PLANS BEING CONTINUED

There are several reasons why equity based LTI plans are being continued and they include the following:

1. For top executives who have a strong influence on long term performance for shareholders it is inappropriate for incentives to be solely or dominantly focussed on short term results.
2. STI plans are open to “game playing” by executives as they participate in the setting of the goals on which performance is based.

3. Equity based LTI plans provide executives with the opportunity to become long term shareholders. Thus, the incentive to work for the good of shareholders continues well after the vesting period has been completed.
4. Tax can be deferred for many years after vesting thereby increasing the value to executives.
5. The benefit received by executives will, in successful companies, greatly exceed the cost as represented by the accounting charge, whereas if a cash plan were to be used the benefit would equal the accounting charge/expense.
6. Cash can be preserved by companies if they issue the shares under the LTI plan.
7. Some Boards have taken the view that CEOs and key executives should not participate in STI plans due to their involvement in both the business planning and implementation processes. In these situations, to also remove the LTI would result in no part of the remuneration package being performance related which would not be consistent with best practice.

CONCLUSION

There has been some replacement of LTI plan participation with increased STI awards but mainly for lower level executives and managers who hold roles which probably should not have been participants in LTI plans in the first place. Where this has occurred it has tended to be in the form of increased STI awards with the increase being in the form of grants of shares or rights which vest based on completion of a period of service, typically 2 to 3 years.

For top executive roles, equity based LTI plans rightly continue to form a major part of remuneration packages. However, consideration is being given to the nature of the vesting conditions so that there is a better correlation between the accounting charge and the vesting of LTI grants. Such considerations have not been easy to resolve as institutional investors prefer the vesting condition to be TSR which is a market condition whereas to correlate vesting with the accounting charge requires non-market conditions to be used.

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GRG Contacts

GRG is well positioned to assist boards in reviewing their company's remuneration strategies, incentive plans and employment contract terms. Many of the top Australian listed companies are among our substantial client base.

GRG maintains databases on director and executive remuneration. We capture all the aspects required to be covered in Remuneration Reports and therefore provide an authoritative source of advice in relation to market practices and emerging trends.

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More information on GRG may be obtained from our website: www.godfreyremuneration.com