Incentive Performance Targets

Denis Godfrey and James Bourchier | July 2015

Introduction

An aspect of incentive plans that seems to cause confusion among Remuneration Committee members and executives is the setting of targets. This GRG Remuneration Insight canvasses the considerations that need to be taken into account and aims to present an approach that will assist in developing a consistent, defensible and logical process for target setting as part of the senior executive remuneration process.

Remuneration Profiles

A remuneration profile is the mix of the elements of remuneration that comprise a total remuneration package (TRP). Typically short term incentive (STI) and long term incentive (LTI) are expressed as percentages of the Base Package (also known as FAR, TFR, EC etc.). For example a remuneration profile may be composed as follows:

Remuneration Element	Expressed as % of Base Package	Expressed as % of TRP
Base Package	**100%**	57%
STI	**30%**	17%
LTI	**45%**	26%
TRP	**175%**	100%

The third column "Expressed as % of TRP" is the way that actual outcomes need to be disclosed in Remuneration Reports, however it is not the way that companies usually set award opportunities for STI and LTI plans. The middle column reflects the way that most companies set and communicate STI and LTI award opportunities. The question is whether the STI and LTI percentages are for stretch or target performance.

Target or Stretch

Before discussing whether target or stretch or both should be communicated to executives it may be helpful to define some relevant terms.

Term	Meaning
Threshold	This is the minimum level of performance that warrants payment of a small incentive. It represents a near miss i.e. relatively close to the target outcome. Probability of around 90%, or should be achieved or exceeded in 9 out of 10 years

Term	Meaning
Target	This is a challenging and achievable level of performance. It is a commendable level of performance. Probability of around 60% or should be achieved, or exceeded in 6 out of 10 years.
Stretch	This is an outstanding level of performance that would be expected to be rarely achieved. Probability of around 10%, or should be achieved or exceeded in 1 out of 10 years.

GRG has seen instances where employment offers have included incentive award opportunities of "**up to"** x% of Base Package. Further, when questioned about whether the maximum is intended to be target or stretch there is often a lack of clarity. When the "up to" amount is the stretch there is often a lack of clarity as to the intended target award opportunity. If there is lack of clarity in the mind of the person making the offer there cannot be clarity in the mind of the executive receiving the offer. Accordingly, there will be no shared understanding of the terms of the incentive to be offered. A consequence of the lack of clarity can be aggravation between the executive and the company and poor motivational impact. Clearly such circumstances should be and may be easily avoided through the use of appropriate language and a focus on target rather than on stretch in communications.

A critical difference between target and stretch is that generally stretch should be rarely achieved. Target should be achieved when commendable performance is achieved which should be regularly for fully competent teams of executives. Accordingly, executives should expect to receive at least target awards in most years. At the same time they should also expect their incentive awards to reflect performance such that when performance is poor they will receive less than the target award opportunity including nil when appropriate. Similarly when performance exceeds the target level they should expect actual incentive awards to be more than the target award opportunity.

Target and Budget

In relation to STI plans there is often a lack of agreement among Remuneration Committee and Board members as to whether the budget should be used as the target level of performance. The answer depends upon how the budget is set. If the budget is expected to be comfortably achieved then it may be more appropriate to use it as the threshold level of performance. If the budget is challenging and achievable then it would be suitable for use as the target performance level. If the budget is aspirational then it may be more appropriate to use it as the stretch level of performance.

Remuneration Report Disclosures

Each year shareholders are asked to vote on Remuneration Reports of ASX listed companies and if 25% or more of the cast votes are against the relevant resolution then the company is said to have received a "strike". Shareholders and the proxy advisors who provide guidance on how votes should be cast by shareholders have a keen interest in understanding incentive remuneration plans within the context of a total remuneration strategy.

Keys to this understanding are clear explanations of the key performance indicators (KPIs) being used, the performance ranges applicable to the KPIs and the award opportunity ranges that are aligned to the performance ranges. If a company is not clear as to threshold, target and stretch levels of performance then it will not be able to produce high quality Remuneration Reports that meet the needs of its shareholders and their proxy advisors.

Formal Policies and Procedures

Often the lack of clarity as to incentive award opportunity targets reflects the fact that companies have not adopted formal policies and procedures governing executive remuneration and incentive plans. All companies that use grants of equity for their LTI plans have formal LTI plan rules. However, few companies have comprehensive policies and procedures governing executive remuneration, STI, LTI and equity holding guidelines for executives. Some even do not have plan rules for their STI plans.

Once policies and procedures have been drafted and adopted they provide a valuable guidance framework and reference source for Remuneration Committees when reviewing various aspects of executive remuneration. Just as important is the process of developing the policies as it involves consideration of all of the important aspects to be covered in the policies and procedures.

Given that Remuneration Reports need to be audited, the existence of formal policies and procedures will provide the evidence required by the auditor to confirm that the material presented in the Remuneration Report as the company's policy is accurate.

Consensus Forecast and Company Strategies

Proxy advisors are increasingly assessing the appropriateness of KPI, performance ranges and award opportunity ranges by reference to consensus forecasts and the company's disclosed business strategies. Although forecast can vary there is nevertheless a clear expectation that the incentive plans will be aligned with both of these reference points and that variance will be explained.

To avoid concerns that may be reflected in negative votes on Remuneration Reports it is important for commentary in Remuneration Reports to either confirm the alignment of incentive practices with consensus forecasts and company business strategies or explain why the incentive plans may appear to be out of such alignment yet are appropriate to the company's circumstances.

Risk Management

Managing risk has emerged as a consideration when setting performance goals in relation to KPIs for STI plans and vesting conditions for LTI grants. Particularly when setting stretch performance goals and the additional incentive award opportunity that may be earned when they are achieved, care needs to be exercised to ensure that executives are not encouraged to take excessive risk.

For some KPIs and vesting conditions a moderating element may need to be incorporated to ensure that excessive risk is not rewarded or encouraged. By explicitly incorporating a risk element into performance assessments all participants will be aware of the importance of maintaining risk within the company's appetite for risk.

While LTI plans can cause executives to consider the longer term implication of business decisions including the risk exposure, LTI plans have limited impact on risk due to vesting periods of 3 years being relatively short and there being no explicit focus on risk. Perhaps requiring executives to maintain longer term shareholdings may have more impact on optimising risk exposure.

Basics of a Sound Policy

Following are the basics of a sound remuneration strategy and the resultant remuneration profile.

1. Establish a market positioning policy for Base Packages e.g. P50/50th percentile of market Base Package practice,
2. Establish a market positioning policy for TRP e.g. P75/75th percentile of market TRP practice, applicable to **target** performance (recognising that the maximum potential award opportunity would exceed the target award opportunity for outperformance of targets),
3. The gap between the Base Package and TRP policies represents the **target** level of STI and LTI combined,
4. The mix of target STI and LTI is then determined having regard to the time impact focus of the category of executives e.g. direct reports to the CEO (it would also take into account whether part of the STI is to be deferred into equity or fully paid in cash),
5. For each KPI in the STI plan and for each vesting condition in the LTI plan consideration needs to be given to the extent of outperformance that may be achieved, if any, and the level of stretch award opportunity that will be attached to that outperformance.

An important point to note in relation to the foregoing is that target is a durable reference point for policy setting as it should represent a consistent level of difficulty, is applicable in the case of both binary and non-binary measures and ought to be the reference point for defining other points (such as target and stretch) where multiple reference points are appropriate. Stretch/maximum on the other hand is generally not useful in setting policy because while target and maximum may be the same in the case of binary measures, this is not the case for non-binary measures. Stretch tends to be an outcome of decisions made in relation to KPIs, having consideration for the elasticity of targets and the impact of outperformance on overall company success, which tends to change from year to year depending upon decisions made in relation to annual offers under STI and LTI plans.