GRG **Remuneration Review**

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Short Term Incentive Plans for KMP

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Introduction

Recent Press articles on key management personnel (KMP) remuneration disclosures in Remuneration Reports seem to expect that disclosed remuneration levels from one year to the next should be lower if shareholder value has declined. Boards are often criticised and remuneration strategies are tagged as not working when disclosed remuneration levels have not fallen in line with falls in shareholder value. The rationale for such views seems to be that there is only one measure of performance over the short term (year on year movements are usually the focus of the Press articles) and that is the returns achieved by shareholders.

When the main elements of disclosed KMP remuneration are analysed it follows that the Press is of the view that short term incentives (STIs) should be based on annual growth in shareholder value which is the returns received by shareholders from dividends and growth in the share price. Two of the main elements of disclosed KMP remuneration tend not to change in response to changes in shareholder value. These two elements are Base Packages and long term incentives (LTIs). The reasons for the disclosed values of these elements not changing in line with movements in shareholder value include:

a) The Base Package is a fixed amount which tends not to be reduced except in extreme circumstances such as the global financial crisis (GFC) and tends to be increased in line with market movement or change in the size of the job, and
b) The values of LTIs that are disclosed are the amortised values of the grants of shares, right and/or options and these values do not vary with company performance or changes in shareholder value if the vesting conditions are market related which is the most frequently applied type of vesting condition. Of course, the benefits realised by executives from LTIs do vary in line with movements in share prices.

Thus, the major element of KMP remuneration that drives year on year changes in reported remuneration levels is the STI. The Press articles trigger two questions being:

- should STI payouts be aligned with changes in shareholder value, and
- if so, then how might such an alignment be achieved?

Should STI Payouts Be Aligned With Changes In Shareholder Value

The long standing view of STI plans is that they should be aligned with company performance over a one year measurement period. LTIs provide an incentive to improve performance over the longer term. Company performance is a different concept to shareholder value although it is generally expected that sustainable improvements in company performance will translate into growth in shareholder value. Even when growth in shareholder value does relate to an improvement in company performance it may be delayed until shareholders accept that the improvement is sustainable or it may precede the improvement if shareholders accept that a new strategy will in the future deliver improved company performance. The time when shareholders accept the company performance improvement is the time when the share price will increase. It should also be noted that changes in shareholder value may, in the short term, be unrelated to underlying company performance.

During the first wave of the global financial crisis in 2008 and the current second wave share price falls have driven declines in shareholder value. These share price declines have been due to perceived higher risk requiring higher returns and pessimistic views on future performances of companies. The factors that have led to the decline in shareholder value have often been unrelated to recent company performance.

Nevertheless, when shareholder value does move up or down in the short term in response to changes in company performance there is an argument that STI plans should reflect such changes.

How Might STI Plans be Aligned with Changes in Shareholder Value

There may be several ways in which STI plans may be better aligned with changes in shareholder value and these include:

- Applying a shareholder value gate to STI payouts,
- Applying a shareholder value change modifier to STI payouts,
- Making shareholder value the sole or dominant key performance indicator (KPI), and
- Requiring part or all of STI payouts to be in the form of grants of company share rights.

Each of these is discussed below.

Shareholder Value Gate

A gate for an STI is a level of performance that must be achieved before any participant in the STI may receive a payout. The purpose of a gate is to protect the company from having to make STI payouts in circumstances where to make the payouts would be inappropriate given the poor level of company performance and/or decline in shareholder value. While gates are usually based on company profit it is possible to set a gate related to shareholder value. Examples include: shareholder value must increase by at least 5%, shareholder value must not decline or must not decline by more than 5%.

Shareholder Value Modifier

A shareholder value modified could be applied such that the amount of STI payouts will be increased or decreased by reference to changes in shareholder value over the financial year. The following table presents a possible approach to a shareholder value modified:

Change in Shareholder Value	Modifier
≥+20%	1.5
≥+5% & <+20%	1.25
≥-5% & <+5%	1
≥-20% % <-5%	0.5
≤-20%	0

The STI payout would be multiplied by the modifier to calculate the actual amount of STI payout for the year.

Shareholder Value KPI

Several KPIs are usually used in STI plans. Some relate to company performance, other to business unit performance and others to individual performance. The company and business unit performance KPIs tend to relate to profit and other important indicators of performance. They usually do not relate to changes in shareholder value.

Changes in shareholder value are usually used in relation to LTI plans and typically relate to total shareholder return (TSR) which is another term that is used to refer to changes in shareholder value.

In LTI plans, TSR performance is usually measured by reference to relative and/or absolute TSR. Similar approaches may be applied to STI plans with the only difference being the measurement period which would be one year instead of the three or more years that are typically used in LTI plans.

STI Payouts in Shares

Prior to the changes in the employee share scheme (ESS) taxing provisions which came into effect on 1 July 2009 there had been growing incidence of part of STI payouts being in the form of shares which were fully vested but could not be sold for a period of up to say three years. Under the current ESS taxing provisions, tax deferral will only apply to shares granted as STI payouts if the shares are subject to a real risk of forfeiture.

If company shares were provided to KMP as a partial or full payout of an STI then the shares could be subject to risk of forfeiture and vesting could be based on factors such as completion of a further period of service or growth in shareholder value of a specified percentage over a specified period.

If shares are used then the value able to be realised by the KMP would be related firstly to whether the vesting condition is satisfied and secondly to the value of the shares at the time of vesting. Thus the STI payouts would be more closely aligned with shareholder value. However, the value of the grants would be amortised over the vesting period and whether that value would be varied to reflect vesting would depend upon the vesting conditions applied. If non-market vesting conditions such as service are used then the disclosed value does change to reflect the extent to which the shares vest. If market vesting conditions such as TSR are used then the grant value is discounted to reflect the impact of the vesting conditions but the amortised value does not change irrespective of whether all, some or none of the shares vest.

While the use of shares may improve the alignment of the STI with changes in shareholder value it will not appear so in the mandatory disclosures in the Remuneration Report due to the accounting treatment of grants of shares. Companies could consider improving the Remuneration Report disclosures by providing more detail on the relationship between actual reward received and performance.

Review of STI Plans

If your Remuneration Report has been criticised or your board is concerned that it may be criticised then it may be appropriate to have the remuneration strategy and the individual elements of KMP remuneration critically reviewed. The STI will be one element that may need careful consideration and to be varied to improve the relationship to changes in shareholder value and perceptions of fairness. GRG is well placed to undertake such reviews.