GRG Remuneration Insight 84

Using Terminology to Improve Communication

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Introduction

GRG has observed that the use of imprecise terminology in engagement letters, policies, plan rules and Remuneration Reports often leads to a lack of clarity regarding intended total remuneration packages (TRPs). Poorly expressed engagement letters have resulted in friction between senior executives and the Board due to different interpretations of the intended TRP outcomes. Imprecise expressions of policy can lead to concerns amongst shareholders and proxy advisers regarding the reasonableness and appropriateness of TRP. This GRG Remuneration Insight discusses some of these issues and proposes terminologies that should alleviate these problems.

Common Examples of Poor or Unclear Communication

STI Target Award Opportunity

There seems to be no consistency in the way that companies refer to short term incentive (STI) award opportunities. Examples include:

a) Senior executives may earn an STI payment of up to 50% of their Base Package/FAR/TFR,

b) Senior executives have a target STI award opportunity of 50% of their Base Package/FAR/TFR,

c) Senior executives may expect to earn an STI of at least 50% of their Base Package/FAR/TFR depending upon performance.

At first glance these three examples may appear to be similar. However when applied to typical STI plan structures that have a threshold, a target and a stretch/maximum the outcomes can be very different as shown in the following table:

STI Award Opportunity Levels	Situation a)	Situation b)	Situation c)
Outstanding/Stretch	50%	100%	200%
Target	25%	50%	100%
Threshold	12.5%	25%	50%

Situation a) would most likely lead to tension between the Board and senior executives if senior executives expected to earn most or all of the 50% award opportunity for delivering a solid performance outcome, which is typically considered to be Target. However, the above table indicates that only 25% would be earned from such Target performance while the 50% is only attainable for stretch/outstanding performance, which is rarely achieved.

Situation b) is unlikely to result in stress between executives and the Board assuming that the target performance level for each KPI is set at a challenging but achievable level.

Situation c) is also unlikely to cause stress between senior executives and the Board but may impede the ability of the Board to attract talent as the offered total remuneration package will appear to be lower than what could be reasonably communicated.

A solution to the foregoing problems would be for companies to use clear consistent terminology with consistent agreed-upon definitions.

LTI Award Opportunity

Long term incentives (LTIs) are usually expressed as percentages of Base Packages/FAR/TFR. Usually, an executive's letter of appointment will indicates what percentage of Base Package, for example 30% of Base Package, is for target LTI. What many companies do is to convert that offer into an annual grant of Performance Rights by dividing the LTI intended amount by the share price using a 10 trading day VWAP. For example if the Executive's Base Package was $400,000 the 30% LTI would be $120,000. Based on a Share Price of say $5.00 the Performance Rights to be granted would be calculated by many companies to amount to 24,000. ($400,000 x 30% ÷ $5.00).

An executive will not be happy with the 24,000 Performance Rights allocation as his/her expectation would have been for a Performance Rights grant of at least double that amount. The reason for this massive discrepancy is that Executives know that according to most LTI vesting scales usually only half the LTI will vest for Target performance and the full LTI can only be realised if the unlikely outstanding performance level is achieved.

The executive had expected the LTI value of 30% of his Base Package to be the value that would be receive if a good/challenging level of performance (not outstanding) were to be delivered. Clearly, the expectations of the Board and the executive are not aligned in this case and this problem could have been overcome with more transparent communication at the outset.

Moreover, numerate executives will also know that they will not be receiving dividends during the plan period so the share price value used to calculate the Performance Rights allocation is inflated by the dividend amount built into the share price. So for example based on a $0.20 yearly dividend foregone for the life of a 3 year LTI vesting plan the $5.00 VWAP Share Price used to calculate the number of Performance Rights is essentially $4.40. This in turn will result in a grant of 54,545 Performance Rights to deliver 30% LTI value of $120,000 for Target Performance (more than double what was offered).

Policy Specification

Two main anchor points are used to express KMP remuneration in terms of market positioning being: Base Package (Fixed Pay or FAR/TFR) and TRP (Base Package plus all incentives). If the market positioning for Base Package and TRP were at the market's 50th percentile pay level for both remuneration measures, then the excess of the P50 Base Package over the P50 TRP will need to be filled with incentives. However, will the excess to be covered with the STI/LTI quantum be at threshold, target or stretch performance levels?

The chosen performance level will have a significant impact on the market competitiveness of the TRP. If threshold is used then the TRP will likely be far more competitive than the P50 policy market positioning; while if target is selected then the TRP will most likely be as market competitive as the policy planned. However, if stretch/outperformance is selected then the TRP will be far less competitive than intended by the policy.

In Remuneration Reports it is necessary to show the percentage mix of the elements of the TRP. If the mix is based on actual STI awards and the value of actual LTI grants then the mix says little about policy and a lot about outcomes. If stretch/outperformance levels of STI and LTI are used then the mix says something about potential but little about intended remuneration levels for executives. On the other hand, if target levels of STI and LTI are used then the mix indicates the relative weighting on each element in normal operating circumstances.

From a communication point of view target award opportunities are generally the most appropriate level of incentive opportunity to be included in TRPs and policies governing TRPs.

Market Remuneration Practice Information

Most market remuneration databases rely on publically disclosed information from Remuneration Reports. They contain sound data on Base Package/FAR/TFR levels as the accounting standards require consistent approaches to be applied when valuing Base Packages/FAR/TFR. However, when it comes to incentives the data may either relate to actual disclosed values as per the accounting standards or policy data.

Actual incentive data has, for many years, been seen as a reasonable but understated reflection of policy because:

- Actual STI awards tended on average to approximate target awards, and

- Most actual LTI value took into account market related vesting conditions which means that the grant value was amortised on a straight line basis over the vesting period with no adjustment for actual vesting outcomes.

In recent years, however, the disclosed incentive amounts have become less representative of policy levels due to:

  - STI awards being low due to challenging economic circumstances which meant that goals were not being met, and
  - The use of non-market vesting conditions for vesting of LTI grants has increased which in turn has led to more volatility in disclosed LTI values including negative values when vesting expectations needed to be revised downwards.

As a response some databases now include (or will need to include) target levels of STI and LTI award opportunities to reflect company remuneration policies. While the theory that has led to this modification of databases is soundly based, the practice continues to be problematic because many companies do not disclose policy levels for incentives making it impossible to include target levels of incentive award opportunities. On the other hand, those companies that do make some level of disclosure of policy incentive award opportunities do not use consistent terminology. Hence, it can be challenging, if not impossible, to determine what are the true target incentive award opportunities.

In view of the above, it is in the interests of all involved in KMP remuneration to disclose target incentive award opportunities on a consistent basis in Remuneration Reports.

Consistent Communication Terminology

Based on what has preceded, most of the problems that arose from the foregoing examples and practices can be overcome by using the following three defined terms:

Term	Definition
Threshold	A level of performance that represents the minimum for which an incentive award may be earned. Performance below this level does not warrant any incentive payment.
Target	A level of performance that is challenging but achievable. It represents a solid level of achievement that warrants a meaningful level of incentive payment.
Outperformance or Stretch	A level of performance that is outstanding and a clear exception to what may normally be expected to be achieved otherwise, and which warrants a very high level of incentive payment. However, it is a performance level that is rarely achieved.

Of these terms “target” is the most important as the incentive that may be earned for delivering this level of performance is the incentive that should be included in the total remuneration package that is communicated to prospective and current employees.

It should also be noted that the terms involve an interaction between incentive award opportunity level and the performance level required to earn the incentive payouts. In many cases the target performance level will be the budgeted outcome. This should be the case when the budget is challenging but achievable. If the budget is less challenging or aspirational then it should not be used as the target.