GRG Remuneration Insight 63

Short Term Incentive Fundamentals

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INTRODUCTION

Short term incentives (STIs) are a common element of key management personnel (KMP) remuneration. However, the level of understanding of when an STI should be used and how its design features should be constructed seem not to be well understood by many stakeholders. This GRG Remuneration Insight seeks to provide clarity as to the fundamentals of STI plans. Market practice information quoted in this GRG Remuneration Insight has been extracted from the 2014 GRG Incentives Guide.

WHAT IS AN STI PLAN

When referring to STI plans most Remuneration Committees have target based STI plans in mind. Target based STI plans are plans were key performance indicators (KPIs) are selected, weighted, given goals and have award opportunities attached. They are distinct from profit share plans where a percentage of profit or profit above a threshold is allocated to a pool which is then shared amongst participants. It is also different from discretionary bonuses where the amount of the bonus is determined in the discretion of the Remuneration Committee perhaps after consideration of performance in relation to business plans and/or individual goals.

SHOULD ALL ASX LISTED COMPANIES USE STIs FOR THEIR KMP

The simple answer is no. Companies that have not achieved profitable operations should generally not provide STIs for their KMP. This is not to say that they should not be provided with incentives but the incentives should probably be long term and securities-based to preserve cash, rather than cash based STI plans.

Also companies can be at different stages in their evolution. Often startup companies need to be flexible to adapt to evolving circumstances and emerging opportunities. When business plans cannot be set with a high degree of predictability then it will generally not be appropriate to a use a target based STI plan. If KPIs and/or goals for KPIs need to change due to evolving circumstance or priorities then a target based STI plan may be counter-productive as it may focus KMP on achieving goals that are no longer appropriate. In dynamic circumstances discretionary bonuses or perhaps a profit share may be more relevant than a target based STI plan. While discretionary bonuses and profit share plans are generally not favoured by proxy advisors and stakeholder groups, support may be obtained if the rationale for their use is clearly explained.

DESIGN FEATURES OF STI PLANS

Measurement Period

Virtually all ASX listed companies with STI plans use their company's financial year as the measurement period. The financial year is the obvious choice as it aligns with budget processes and planning periods. It also ensures that STI awards for financial KPIs are consistent with annual published financial results and therefore the expectations of shareholders.

It is difficult to envision a circumstance when a measurement period of less than one year would be suitable for use in relation to KMP. The planning horizon for KMP roles tends to be 3 or more years yet operational aspects including problem solving challenges tend to be within an annual timeframe.

Longer periods are, of course, used for long term incentives.

Key Performance Indicators

KPIs are the aspects of performance that will be used to assess performance. Examples of KPIs include:

- Economic Profit i.e. profit after tax less a charge for the notional cost of shareholders' funds,
- Profit after tax,
- Profit before tax,
- Operating profit,
- Earnings before interest, tax, depreciation and amortisation (EBITDA),
- Return on capital employed (ROCE),
- Production,
- Cost per unit of production,
- Health & Safety, and
- Personal effectiveness.

Note that revenue may not be used as a KPI for directors (see ASX Listing Rule 10.17) and therefore probably should not be used for any KMP.

Performance Goals

Performance goals relate to KPIs and are the levels of achievement that warrant STI awards. For some KPIs the performance goals will be binary in nature i.e. they will either be achieved or not achieved. Others will have a range of potential outcomes in which cases it is usual to set three levels of performance being:

- Threshold which is a near miss or minimum performance that warrants a small STI award,
- Target which is the budgeted outcome when it represents a challenging but achievable outcome, and
- Stretch which is an outstanding level of performance.

Such a range of outcomes and awards has a material impact on behaviour, as the incentive can remain motivating even when the target objective cannot be fully achieved, and outperformance of targets already achieved during the year is additionally rewarded.

Weightings

At target performance each KPI should be allocated a weighting that reflects its relative importance. The total of all weightings should be 100%.

Award Opportunities

The STI award opportunity at target performance should be the amount determined by reference to the target remuneration profile for the role. Typically it will be expressed as a percentage of the Base Package.

All KPIs will have a target award opportunity determined by multiplying the total target STI award opportunity by the weighting for the KPI. For KPIs that are binary in nature the threshold, target and stretch award opportunities are the same (a single outcome being sought) and it is usual to refer to the target only in this case.

KPIs that have a range of potential outcomes should have threshold and stretch award opportunities as well as targets. The amount by which a stretch award opportunity exceeds the target award opportunity is a matter of judgement. It should take into account both the difficulty of moving from target to stretch performance and the additional profit that should be generated for the company by such an improvement in performance. It would not be reasonable to double the target award opportunity for a KPI if the total incremental STI awards for all participants that have the KPI will represent more than 100% of the additional profit.

It is not uncommon for STI plans to confuse target and stretch award opportunities. Evidence of such confusion is when the stretch is called the target and there is no acknowledged target yet STI awards tend to fall around say 70% of the so called target. In these circumstances the real target is 70% of the maximum and the maximum is the stretch level. When there is a lack of clarity it can lead to participants becoming disenchanted with the STI plans as they see the "targets" as not being achievable and therefore feel cheated when they continuously fail to receive the STI awards they feel they have earned through good performance and contractually should have been entitled.

Payouts

STI awards are usually either fully or partly paid in cash via payroll with PAYG tax deducted. Increasingly companies are deferring part of STI awards into deferred Rights (rights to the value of a share in the company which may be paid in shares and/or cash when they vest). Deferred Rights usually vest on completion of 1 or 2 years of service and where multiple years of deferral applies, some vesting usually occurs on each anniversary of or at the end of each financial year since the beginning of the deferral period, often in equal portions.

Termination of Employment

If a KMP ceases employment during a measurement period it is usual for entitlements to be forfeited in cases of dismissal for cause or resignation. In other cases entitlements may not be fully forfeited.

If the company decides to make a pro-rata STI award on termination of employment then the payment will constitute a termination benefit. The total of all termination benefits for KMP must not exceed the Corporations Act default limit of one times base salary unless prior shareholder approval for a higher termination benefit has been received. The treatment of "good leavers" needs to be carefully crafted to avoid unintended termination benefit problems. Most companies appear not to have yet revised their incentive plan rules to address this issue and often are not aware of the problem until a good leave situation arises, at which point it is too late to address.

Change of Control

Market practice for STI plans in relation to change of control situations is not clear as it is an aspect that is not covered in most Remuneration Reports. However, it should be noted that early payment of STI awards that are triggered by a change of control would not be subject to the Corporations Act termination benefit limit.

Risk Assessment

An important feature of STI plan design and implementation is to ensure that excessive risk is not encouraged and that recovery of STI awards is available should the achievements that have been rewarded turn out to be not as beneficial for the company as expected. In this regard, consideration should be given to excluding those who are responsible for risk assessment and financial reporting from participation in STI plans. For APRA regulated financial institutions this is a requirement.

STI Policies and Plan Rules

An STI policy is one component of a Remuneration Governance Framework. It should sit alongside the LTI policy, the senior executive remuneration policy and the non-executive director remuneration policy. The STI policy and procedure should be separate from the STI plan rules. STI plan rules like the LTI plan rules need to cover all of the essential plan design features yet leave sufficient flexibility for the Board to modify specific offers to meet the changing circumstances and needs of the company.

On many occasions GRG has found that clients either do not have an STI policy or plan rules or have inadequate documentation. Having complete documentation can aid in conflict resolution and its preparation can ensure that critical plan design and policy decisions are taken objectively. They will also support preparation and audit of the Remuneration Reports and are essential to both good governance and continuity as the composition of the Remuneration Committee changes over time.