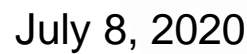

July 8, 2020

Tips to Evaluate Discretionary Action for Executive Incentives in Australia

Examining the role of board discretion in determining executive incentive payouts for Australian firms amid the COVID-19 pandemic and considerations for FY21 incentive plans.

The effects of the COVID-19 pandemic have been felt far and wide from both a business and humanitarian perspective. Several organisations have adopted measures, such as pay cuts, layoffs, furloughs and material reductions in spending to stay afloat. The current economic outlook in Australia does not look promising, indicating further business challenges in the coming months.

Financial performance for many companies has been significantly affected by the prolonged hiatus in economic activity around the world. On the other hand, we saw a surge in business for certain industries that provide in-demand services. This volatile environment will likely be reflected in the outcomes of executive incentives. Boards will have to determine, in accordance with their organisation's own unique circumstances, if the payouts dictated by incentive plans require discretionary adjustments to smooth out short-term instability and reflect normal business performance. Discretionary adjustments are not uncommon and usually carefully scrutinised by investors and shareholders. Unsurprisingly, in years of constrained financial performance, investors are more likely to disagree with upward discretionary adjustments in the prevailing governance environment notwithstanding the actual contribution of the executive team.

In this article, we explore considerations for boards when making discretionary decisions on executive incentives in the current environment and the various forms that board discretion could take.

Applying Board Discretion to Executive Incentives

Board discretion is always a contentious topic. However, due to recent events — including the findings of the Royal Commission regarding misconduct in the banking, superannuation and financial services industries, the Australian Prudential Regulation Authority's (APRA) review of the remuneration practices of the country's largest financial institutions, and highly publicised scandals in some key banks — the requirement and expectation for boards to apply sensible discretion over incentive plan outcomes is even more pronounced.

What's more, investors continue to push for alignment of executive pay with company performance and environmental and social goals, as well as greater levels of transparency in communication of targets and remuneration outcomes. Last year saw the highest number of remuneration strikes recorded in Australia since 2011.

Given these trends, we advise boards to view any potential discretionary actions due to the COVID-19 pandemic in the context of a larger framework of considerations. There is clearly no one-size-fits-all solution when it comes to managing the impacts of force majeure events on executive remuneration. However, there are some key

considerations in determining if discretionary actions can be justified. Figure 1 highlights the various factors that need to be weighed when considering discretionary actions.

Figure 1

Key Factors to Consider When Taking Discretionary Action on Incentive Payouts

To delve into this further, below we outline potential considerations for boards when applying discretion to executive remuneration:

Key Actions	Areas to Consider
What is the extent of impact on shareholders?	Any discretionary action around incentives will always be evaluated by shareholders through the lens of, among other things, share price movements and dividend payouts. Some investors may take the view that no incentives should be payable to executives when the share price has declined over the performance period. Organisations utilising relative total shareholder return (RTSR) as a performance metric in long-term incentive (LTI) plans may not need any discretion if peers have been similarly impacted by declining share prices. Still, a decline in share price by itself may indicate disapproval of certain shareholders for any payouts, even if RTSR is at or above median. In such instances, LTI payouts would have to be supported by both strong reasoning and a positive or improving business outlook.
How severely was the organisation impacted by the event?	In cases of severe impact, which include a material hit to market valuations, company financials and business outlook, it is difficult to justify any additional spend on discretionary incentives for executives. Additionally, for equity-based plans, investors may prefer that organisations conserve cash instead of buying equity off the market to allocate to executives. Even issuing new equity, which further dilutes existing

	shareholding, may also not be preferable, particularly when no dividends have been paid and/or TSR is negative. For moderate impact, there may be some financial leeway to exercise positive discretion where plan outcomes do not dictate any payouts. However, this would need to be executed with extreme caution and accompanied by proactive and effective communication of the rationale to investors, in addition to being weighed against other factors as outlined. In cases where business impact is minimal, there may be no need to apply any discretion. For a few organisations, there could even be a surge in business performance caused by the extraordinary demand for certain goods and services. In such instances, short-term incentive plans may dictate payouts at maximum levels or close. Again, it’s important to remember that if the share price movement at the end of the incentive plan period is negative, paying short-term incentives at near maximum levels may get questioned. In such cases, boards could consider applying some level of downward discretion to avoid misalignment with shareholder expectations.
Have executive actions proactively and effectively helped preserve business fundamentals and enable a quicker recovery?	Organisations that have taken prompt actions to preserve their financial position may be able to come out on the other side of the crisis in a better position than their peers. In these instances, boards may consider continuing providing incentives to executives even though the short-term financial metrics may indicate otherwise. However, this would also need to account for the projected pace of business recovery. A long, drawn out recovery with sustained subdued business performance may obviate the possibility of any payout. It is therefore worth considering delivery of any discretionary incentives as deferred equity awards, which may vest in a staggered manner over a certain period and be made contingent upon reaching reasonable recovery milestones.
What actions, if any, have been taken for general staff?	Some investors could question executives receiving incentives if there have been severe implications for general staff, such as widespread pay cuts, layoffs or furloughs. In such scenarios, any discretionary incentives for executives will likely be ill-perceived by the broader market. Companies should be careful in communicating the rationale for this and what steps, if any, will be taken to provide restitution for general employees who have also suffered pay cuts.
Should organisations risk losing executive staff, jeopardising their ability to exit the pandemic phase effectively?	Retention of executive talent is a natural priority for remuneration committees. Organisations may feel compelled to act when there is a material risk of losing top talent due to the non-payment of incentives or any ongoing salary cuts. The economic downturn obviously limits the justifiability of incentives for executives as retention tools. Long-term, performance-based retention awards could be considered for specific executives where there is a relatively higher degree of risk, in addition to the normal grant of long-term incentives. Again, this would need to carry with it a very cogent explanation and transparent disclosure of performance conditions. Other considerations, such as the constitutional limit on issuance of equity incentives, internal parity or cost of replacement hiring, would remain relevant as usual.

Specific Actions for Boards to Consider Around FY20 Incentives

There are different ways in which board discretion can be applied when determining the outcomes of executive incentive plans, which will be tested against performance measures at the end of FY2020. One approach is to modify plan inputs and design. Boards can do this through retrospective revision in performance targets. However, this is typically highly contentious and unlikely to elicit a favourable response from most investors. Other ways to modify include:

- Modelling the gap between actual award outcomes and hypothetical outcomes across an adjusted / pro-rata performance period that excludes the impact of the COVID-19 pandemic
- Relaxing gateway conditions
- Introducing or reinstating retesting of performance conditions across an extended performance period; for example, the LTI awards that were set for testing across a three-year performance period to FY2020 could be retested across a four-year period to the end of FY2021

Another approach is modifying the overall outcome of the incentive plan. This can be done by applying an overall percent increase or decrease to the plan outcomes in an upward or downward direction contingent on the organisation’s unique situation, enhancing deferrals of incentives with additional performance conditions, or converting all or a part of a cash-based incentive to equity using a share price averaged over a relatively long period.

Needless to say, discretion can be a hugely contentious issue and several shareholders would be squarely opposed to incentive payouts if they have not made any returns on their investments. Therefore, all discretionary incentives should be supported by a strong business rationale, in addition to being proactive and delivering cogent communication of outcomes to the market.

Looking forward to FY21

From a forward-looking perspective, firms may need to consider adjusting the terms and conditions of their incentive arrangements and equity grants. They can do this by identifying and calibrating performance criteria for incentives in fiscal year 2021 — however, given the uncertainty of recovery, determining absolute targets and setting performance required at threshold and maximum will be challenging. Similarly, determination of the number of deferred shares and LTI performance grants to be awarded amidst significant volatility and unstable share prices may result in overallocation.

The following chart outlines considerations for taking a forward-looking approach to FY21 awards.

Key Actions	Steps to Consider
Performance target setting for the FY21 STI	▪ Potentially delay setting the performance goals for FY21 awards ▪ Determining absolute targets and setting a threshold and a maximum will be challenging; firms could consider drafting broad performance metrics without specifying the exact range of performance targets to adjust them later due to the economic impact

Performance target setting for the FY21 LTI	▪ Add or increase the weight of relative performance hurdles, such as RTSR
Determining the equity grants and vesting terms	The dominant practice for determining the number of rights or shares from the dollar value of LTI and deferred STI is to divide it by the share price at or around the award date. In the current volatility, the number of rights to be issued could vary widely depending on timing. Certainly, for many companies the number of rights granted and the potential dilution could be substantially greater than in prior years. Possible mitigation strategies include: ▪ Move to a number of shares approach instead of a value-based approach ▪ Average the share price over a longer period, such as three to six months, to smoothen the short-term volatility ▪ Use the share price immediately preceding the decline, again to reflect normal market value of the stock

Next Steps

As the 2019-20 financial year has now wrapped up for many organisations in the Australian market, boards should prepare to make decisions around incentive payouts for executives. Any incentive payments to executives will be closely scrutinised by institutional investors and other shareholders, particularly when company financials and market valuation present a sobering picture. The specific areas in which organisations choose to take discretionary action should be determined using very thoughtful consideration of each firm's unique situation, the severity of the impact of the crisis on its business and customers, talent risks and more. Any discretionary action should be rooted in a strong rationale and supported by a proactive, clear and cogent explanation to the market. Forward-looking awards may also require some adjustments, even if only for the FY21 grant, to continue to maintain a good balance between pay and performance and avoid any perceptions of opportunism.

To read more articles on how rewards professionals can respond to the COVID-19 pandemic, please click here.

For additional questions about the impact of COVID-19 on executive incentives in Australia, please contact one of the authors or write to rewards-solutions@aon.com.

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Author Contact Information

Aniruddha Masoorkar
Senior Consultant, Rewards Solutions
Aon
+61 2 9253 8223
aniruddha.masoorkar.2@aon.com

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Additional Contacts

Sydney

Simon Kennedy
Partner and Head of Rewards Solutions
simon.p.kennedy@aon.com
+61 2 9253 8208

Jairus Ashworth
Partner and Lead, Technology Industry
jairus.ashworth@aon.com
+61 2 9253 8201

Alan Jackson
Principal, Executive Remuneration
alan.jackson@aon.com
+61 2 9253 8217

Dawson Wang
Principal, Executive Remuneration
dawson.wang@aon.com
+61 2 9253 8212

Kirsten Ross
Senior Consultant, Rewards Solutions
kirsten.ross@aon.com
+61 2 9253 8381

Rebecca Zhang
Senior Consultant, Executive Remuneration
rebecca.ji.zhang@aon.com
+61 2 9253 8254

Melbourne

Jodie Fraser
Principal, Rewards Solutions
jodie.fraser@aon.com
+61 3 9211 3183

Slesha Devi
Senior Consultant, Rewards Solutions
slesha.devi@aon.com
D +61 3 9211 3269

Perth

Charlotte Hood
Principal Consultant, Rewards Solutions
charlotte.hood@aon.com
+61 8 6317 4071

Steph Drury
Senior Consultant, Rewards Solutions
steph.drury@aon.com
+61 8 6317 4019