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Soft Non-Financial Targets for Incentives

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Introduction

The increase in the use of "soft" non-financial metrics for senior executive incentive purposes has, unsurprisingly, attracted significant stakeholder criticism spearheaded by proxy advisers and the Australian Shareholders Association. Associations such as the ASX Corporate Governance Council, the Governance Institute of Australia and the Australian Institute of Company Directors have not yet entered the fray; but it is difficult to see how they can remain on the sidelines for much longer.

Joining the backlash of large superannuation funds, shareholders, and contrarian fund managers calling for corporate Australia to rein in this practice is influential Senator Nick Xenophon who slammed the growing trend of companies paying bonuses to chief executives for "hitting vague performance targets and for doing what they should be doing in the first place". He indicated that he will raise this issue at the next meeting of the senate economics committee, and has support from the Greens who additionally want to cap CEO pay at a multiple of the wage of average employees in their businesses.

All the above will at least require boards to reassess this practice and prompt them to act sooner rather than later so as to avoid further stakeholder backlash, negative press and even the possibility of legislative regulation. After all, if industry does not self-regulate then it is possible that legislation may be introduced to compel boards to adopt practices that are regarded as reasonable by all stakeholders.

What Are Soft Non-financial Targets?

Metrics that have been criticised as being soft include:

- Safety including nil deaths as a target,
- Diversity and gender equality,
- Employee engagement,
- Culture,
- Customer service/satisfaction/net promoter score (NPS),
- Leadership, and
- Variations of team/individual/strategic effectiveness.

While criticism of these metrics has arisen mainly in relation to short term incentive (STI) plans, they can be just as problematic when used in relation to long term incentive (LTI) plans, if not more so. While short term incentives are often accepted as having an internal focus, LTIs are expected to have strong links with direct shareholder value creation. This is why there is a much narrower range of metrics that are generally considered acceptable for LTIs, than in the case of STIs.

Why Soft Metrics Became an Issue and How to Tackle it?

Many of the soft metrics are seen as being core management accountabilities and part and parcel of corporate responsibility, which if not met should result in termination of employment rather than a bonus for delivery. Other concerns with soft metrics include:

- Lack of clarity and certainty regarding if and how these metrics will create wealth and improve returns for shareholders,
- Difficulty of setting standards of performance in relation to these metrics,
- Lack of transparency as to the measurement of performance in relation to these metrics, which make it difficult for stakeholders to form views on either their usefulness or reasonableness, and
- These soft metrics often take many years to achieve significant and enduring change (if at all), therefore, making them not suitable for use in STI plans; they often lack alignment with the near-term experience of shareholders and may generate incentive awards when a company's annual financial performance is poor.

Perhaps the most significant defect in using soft metrics is the lack of clear alignment with the experience of shareholders. Many stakeholders take the view that management incentive awards should be linked to responsible financial success and not to efforts to achieve such success. If, in a given circumstance, improvements in soft metrics are known to have a positive impact on company financial performance, then management will pursue them with vigour anyway if their STI and LTI awards are linked to company financial performance.

In view of the above, and where a board can articulate a clear case for the necessity of introducing, prioritising and focusing on soft metrics by incentivising them, it may be more appropriate to use them as a **"gate"** or **"modifier"** to generate the STI award, which should still be based on returns and shareholders' experience. For example, and assuming that the company's financial performance is good, if an employee is killed while working then **no** STI should be paid. Similarly, if the company's culture, employee engagement, diversity etc. has not improved then a **reduced** STI would be paid. This should allay concerns that pursuing financial goals only, with no regard for behaviours or other non-financial considerations may undermine long-term value creation.

Are STI Awards Too High?

Perhaps the underlying problem with incentives for senior executive roles is that the amounts payable based on annual results are seen as excessive and perhaps leading to behaviours that are not adequately focussed on delivering long term enduring value to shareholders.

In any event it is possible that criticism of STI awards would be reduced if the balance between STI and LTI were to be shifted away from STI into more LTI, with equity needing to be held for many years and possibly for the full period of the executive's tenure and beyond. This incentive trend is starting to develop overseas and even includes Goldman Sachs and Morgan Stanley.

Conclusion

FY17 STI plans that contain soft metrics as key performance indicators rather than as gates or modifiers should be immediately reviewed to eliminate or at least minimise the use of soft metrics. Further, consideration should be given to the mix of STI and LTI award opportunities and/or to deferral of a large part of STI awards into equity which must be held for many years. At upcoming AGMs shareholders should be advised of the changes that have been made to the STI plans in response to the criticism of the use of soft metrics.