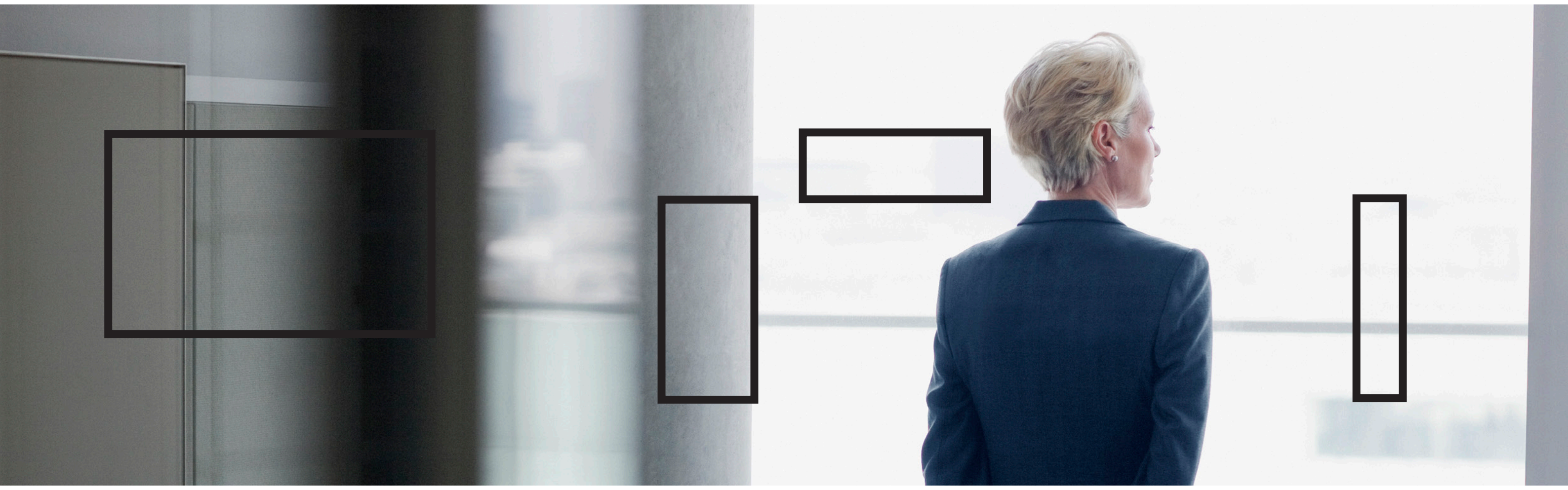
Insights



Unanswered questions about executive incentives in 2020

Asia Pacific insights from the Actions to Restore Stability Survey

By Trey Davis

In their initial reactions to the COVID-19 pandemic, many Asia Pacific-based organisations have focused on human capital, particularly with regard to employee wellbeing and the safe continuation of operations. Most HR teams around the region have also had to address a number of immediately pressing issues such as employee furloughs, physical workplace changes, and the treatment of historically high accrued paid-time off and vacation days.

As such, many organisations have yet to fully address issues relating to executive incentives. Some organisations made annual and long-term incentive awards before the onset of COVID-19, while others proceeded on a business-as-usual basis in making such awards, but with an eye to adjusting performance metrics and goals when more information was available. Regardless of the approach taken, upcoming year-end remuneration committee meetings promise to be long and complicated as Boards tackle a number of complex and potentially controversial topics.

About the research

The COVID-19 Actions to Restore Stability Survey explored how organisations are reprioritising business performance and people objectives to achieve a sustainable reset of their business models.

299 organisations across Asia Pacific, reflecting 2.1 million employees from 14 markets, participated in the survey, which fielded in the region between July 13 and July 27, 2020. This article is based on the responses from 128 organisations which answered the Executive Incentives section of the survey.

Our research found that 65% of respondents were anticipating that COVID-19 would have a small or moderately negative impact on their business in the following six months (the second half of calendar year 2020[1]), and another 15% indicated they were expecting a large negative impact. Ten percent expected no impact, and only 2% expected a positive impact. Looking out over 12 months, the responses were quite similar, with 63% expecting a small or moderate negative impact, 9% expecting a large negative impact, and 3% expecting a positive impact over that timeframe.

[1] 62% of survey respondents indicated that they had a December fiscal year end, 20% indicated a March fiscal year end, and 6% a January fiscal year end.

Annual incentives

Organisations are treating annual incentive plan participants on a broadly consistent basis

A slight majority of survey respondents (56%) are proceeding with an annual incentive plan for their executives which is broadly consistent with last year's, with one-fifth (20%) indicating they have made more substantive changes and nearly as many (18%) indicating they have suspended their annual incentive plan for executives. These responses indicate that many companies are treating their executives differently than for their broad-based incentive plans, which are less likely to be suspended and more likely to be operating relatively normally (perhaps at reduced funding levels reflective of business results).

In our experience, clients in the harder-hit sectors, where there is more pronounced misalignment of goals and metrics with business realities or cash constraints, are more likely to take action than clients in sectors less impacted which are afforded the benefit of a more conservative approach.

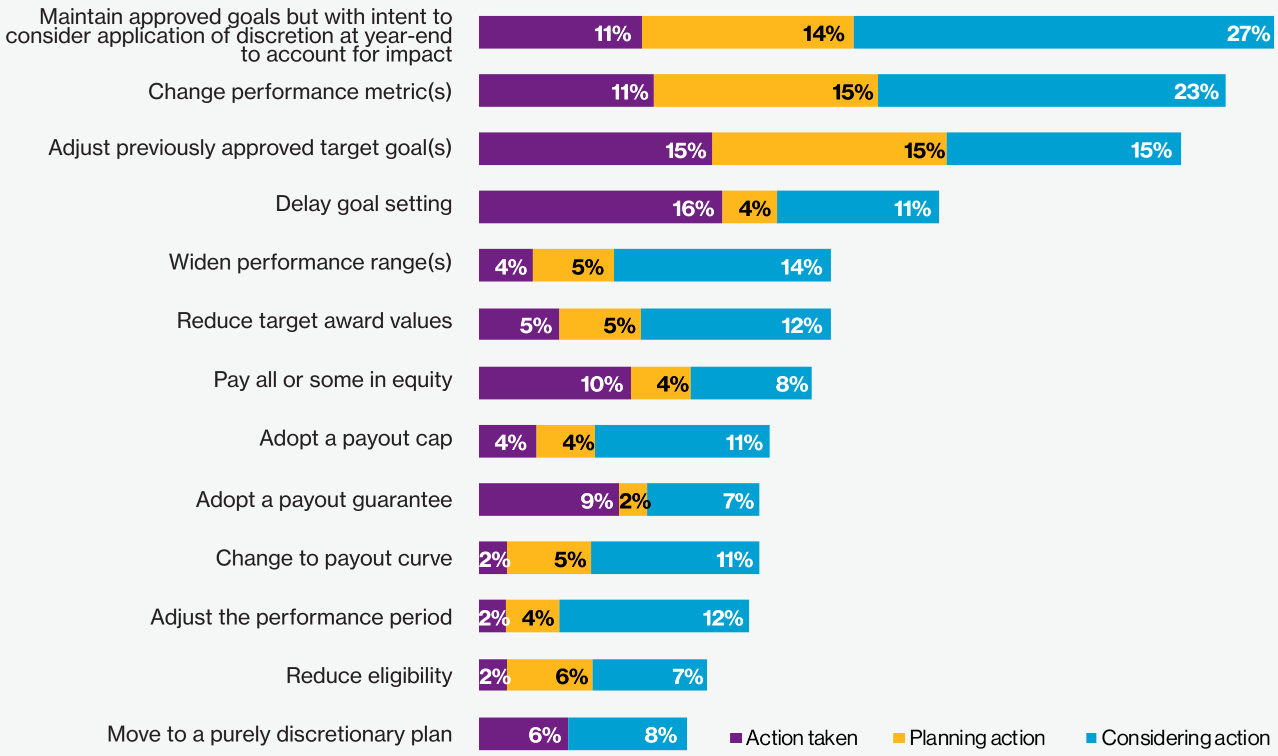
Among those respondents operating annual incentive plans for executives, one-third report they have taken action, and two-fifths are planning or considering changes. The most common responses include delayed goal setting, adjusting previously approved goals, planning for discretion at year-end, and changing performance metrics (*Figure 1*).

The most common response has remained consistent since we started surveying incentive plan actions: employing discretion to assess performance and/or determine payouts (combined 52% of organisations). This is an important discussion to have ahead of time to ensure the appropriate accruals are happening throughout the year.

Many organisations either approved their annual incentive plans prior to the full global onset of COVID-19 or decided to proceed on a business-as-usual basis recognising the near impossibility of goal setting in the current environment. As a result, many plans are tracking below threshold, which may not reflect the efforts being taken by executives and other plan participants.

Figure 1. **Organisations that have taken or are considering specific actions on annual incentive plans this year**

Please indicate the extent to which the following actions apply to annual incentive plans this year for executives in response to COVID-19.



Note: 'Not applicable' excluded. Based on respondents who are operating an annual incentive plan for executives this year.

Where more proactive action is happening, we find the following:

- In earlier surveys a number of organisations indicated an intention to delay goal setting, with most of these saying they intended to finalise goals in Q2. However, many organisations which delayed goal setting have still not set goals. Of those, setting them in Q3 seems to be a more common option than waiting until Q4.
- When target incentive values have been reduced, it is typically by 50% or more. Organisations seem to be ensuring that the savings in payouts are meaningful given the potential employee disruption such changes are likely to cause.

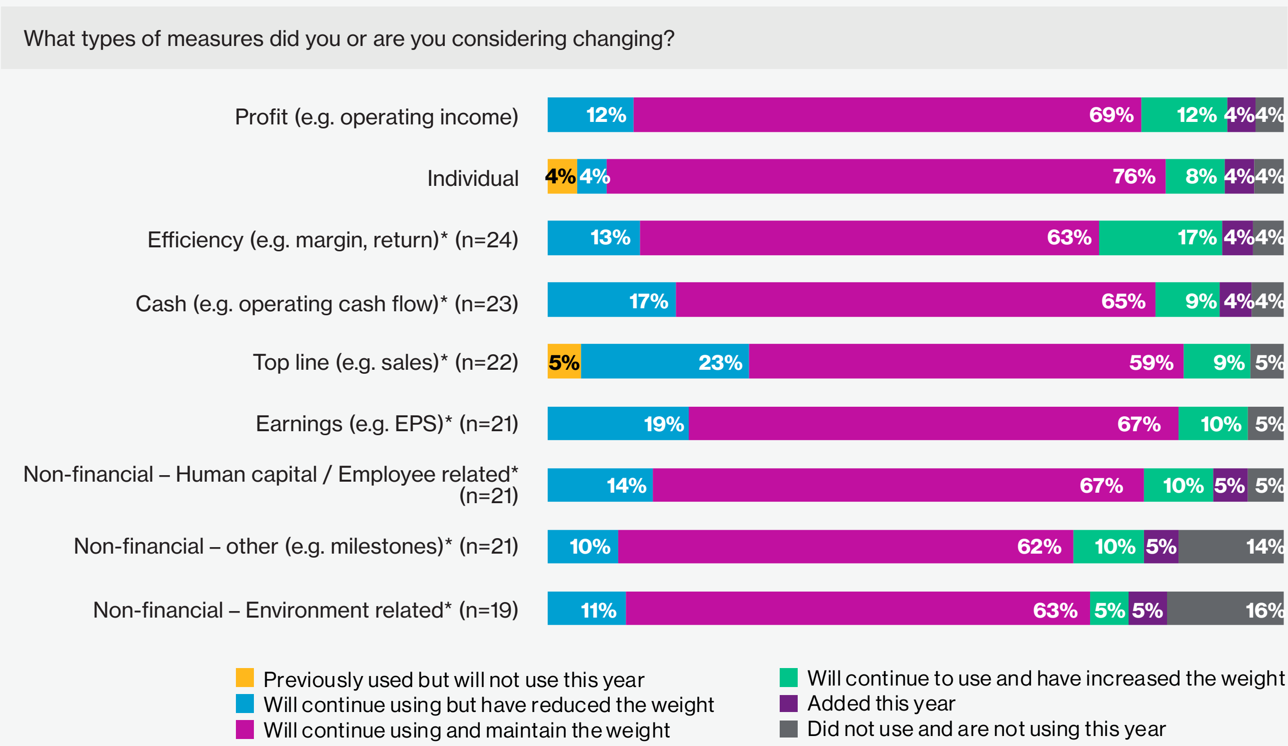
Many organisations' focus has changed significantly due to COVID-19

For many organisations, another significant reason either to consider discretion in the executive annual incentive plan or to move to a purely discretionary one is the diminished relevance of the performance metrics established at the start of the performance period. While in a "typical" year, the organisational focus may be on top-line sales, if customers are not buying (about one in five organisations report that while they are ready to interact with customers, their customers are not ready), that focus is pivoting to areas more within participants' control, such as margin, cost management, cash flow and liquidity.

A minority of organisations (26%) indicated that they have made or intend to make changes to executives' performance metrics. Among these organisations, top-line and earnings metrics were the most commonly observed to have a reduction in weighting within the plan (with 5% of organisations indicating they would remove top line goals from the plans entirely). Where organisations added new metrics, the most common included efficiency (21% adding this metric, or increasing its importance), profits (16%), human capital metrics (15%) and cash (13%) (*Figure 2*).

> **Focus is pivoting to areas more within participants' control, such as margin, cost management, cash flow and liquidity."**

Figure 2. **Changes to annual incentive measures reflected or considered**



Note: *Sample size <25. 'Not applicable' excluded.

A very small number of organisations responded that they either are using annual incentive guarantees or caps, or are planning or considering doing so. A related consideration is the affordability of cash bonuses in the current environment. A minority of organisations (14%) anticipate that some or all of the earned bonus may be delivered in equity.

We expect that the use of human capital metrics in executive incentive plans will increase following this pandemic, as boards and investors become more acutely aware of the importance of effective human capital management. This is perhaps an early sign of bigger things to come. (Read our article on general ESG issues.)

The use of human capital metrics in executive incentive plans is expected to increase following this pandemic.

Long-term incentives

Long-term incentives (LTI) represent a significant investment for organisations – LTIs offer a way to deliver meaningful value while aligning recipients' interests with those of shareholders and focusing executives on key performance priorities. Generally speaking, organisations have a limited appetite for adjusting the terms of already granted LTI awards, reflecting the fact that these awards are targeted at a select group of individuals and the significant disdain among investors for such actions.

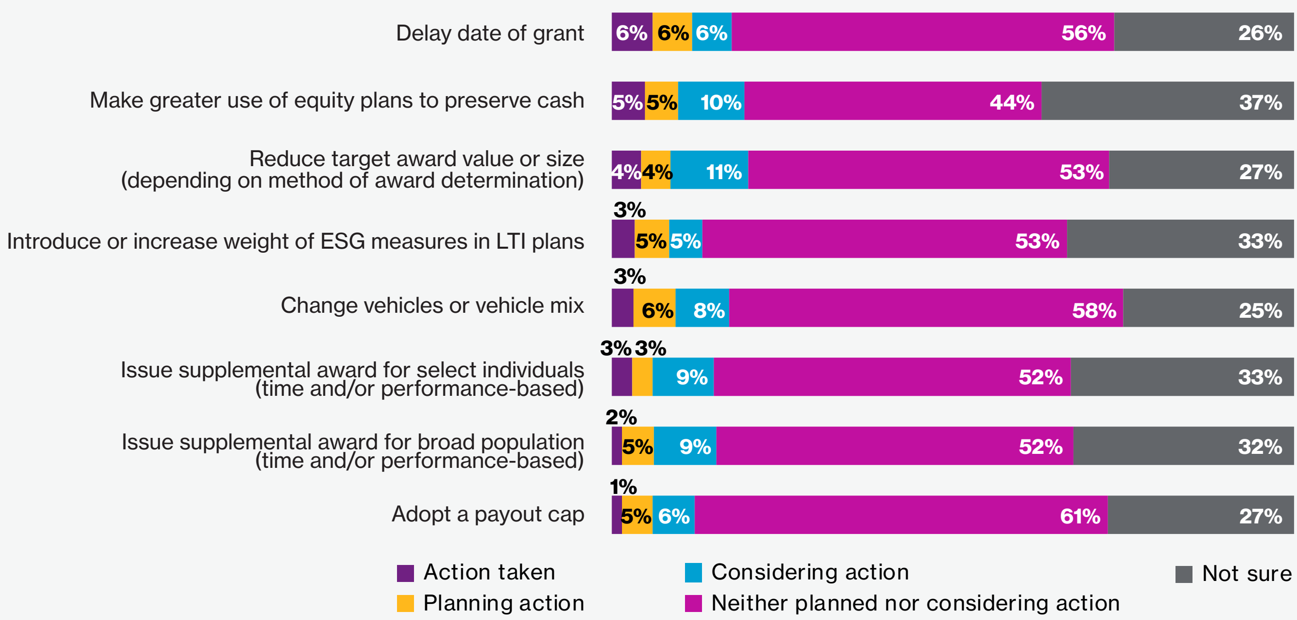
This general reluctance to make adjustments to LTI awards is demonstrated in the fact that only about a quarter of organisations (27%) reported they had already taken action or were planning or considering to take action.

The most commonly considered change is to use equity awards in lieu of cash, with just 5% of organisations having made that change and another 15% planning or considering such a change.

In Europe and especially in North America, we have seen more than one-quarter of organisations making or planning for supplemental equity awards to retain and motivate executives and key staff. In Asia Pacific, there seems to be

Figure 3. **Actions organisations have taken/planned to take on LTI awards this year**

What actions have you taken or are you planning or considering taking with regards to the LTI plans this year for executives in response to COVID-19?



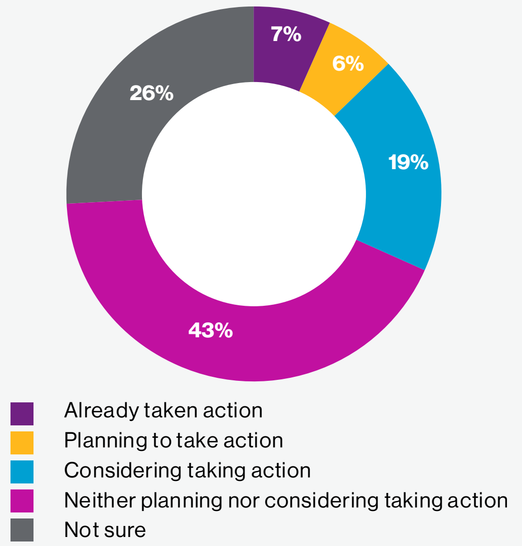
Note: 'Not applicable' excluded. Numbers for percentages below 3% not shown.

much less enthusiasm for supplemental awards, with just 3% of organisations saying they had made supplemental awards to select individuals and 2% saying they had made such awards to the broad employee population. And just 12% to 14% of organisations are planning or considering such awards (*Figure 3*).

When comparing proposed actions on performance-based LTI plans to actions for annual incentives, we see much less appetite for change. Just 7% of organisations have taken action on their performance-based plan (and another 6% are planning action), while 43% of organisations say they are neither planning nor considering action – although 26% are undecided (*Figure 4*). For those that have already made a change, it is most common to delay goal setting. As with annual incentives, a significant percentage of organisations that are considering changes will reserve the right to make discretionary adjustments to the plan at the end of the performance cycle (*Figure 5*).

Figure 4. **Organisations that have taken or are considering specific actions on LTI awards this year**

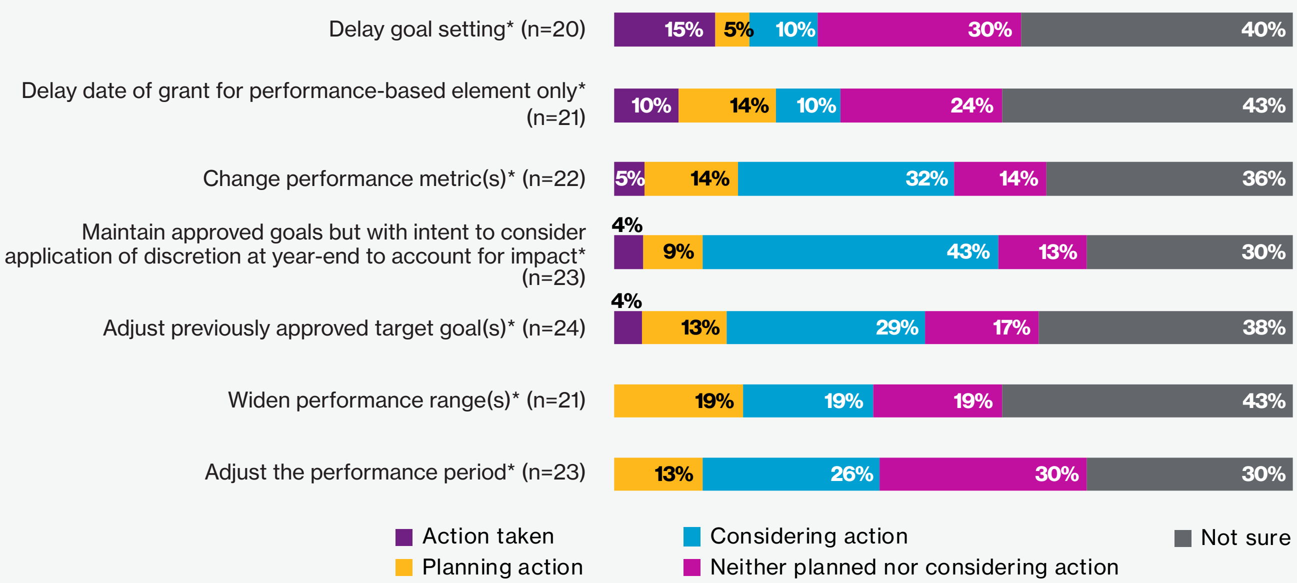
Will you adjust the outstanding performance-based LTI awards?*



*Answers from those who operate a plan with performance conditions

Figure 5. **Actions organisations have taken/planned to take on performance-based LTI awards**

What actions have you taken or are you planning or considering taking with regards to the performance-based LTI plans this year for executives in response to COVID-19?



Note: *Sample size <25. 'Not applicable' excluded.

Start thinking now about disclosure

In many Asia Pacific markets, any actions that impact the compensation of directors or other named executive officers will require disclosure in the annual report. As remuneration committees consider the merits of potential action, it can be helpful to start thinking about how such actions will need to be disclosed and how shareholders and other stakeholders are likely to perceive and react to such actions. Special consideration should be paid to how employees are likely to perceive such actions, particularly in comparison to the actions taken with regards to broad-based employee populations.

To date, large institutional advisors and proxy advisors have been pragmatic, acknowledging that organisations will likely need to apply more judgement to pay and incentive plan decisions than in prior years and they have indicated they are generally open to reasonable adjustments. However, they expect transparent and compelling disclosure, including a detailed rationale, for any adjustments or changes.

Contextualising potential actions through an external lens may help your management team and remuneration committee arrive at better decisions. Read our summary of proxy advisor guidance issued to date.

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