At Your Discretion

How to establish a framework for what comp committee can do with incentive pay.

BY GREG ARNOLD AND MARK EMANUEL

The coronavirus pandemic gave the global economy an unprecedented shock that has raised the stakes for one of the compensation committee's most challenging tasks — determining when and how to apply discretion to adjust executives' incentive pay for circumstances outside their control.

The question of when to make discretionary adjustments is always a tricky one. Although the impacts of COVID-19 have been sudden, significant and unexpected, it is important to remember that 2020 was already shaping up as a particularly challenging year for incentive goal-setting. The U.S. economy was marching toward its 11th year of economic expansion and the potential for tariff wars, Brexit and an upcoming U.S. election all added to a heightened level of uncertainty. The pandemic has simply accelerated the urgency to establish a framework for what compensation committees will and won't do to apply discretion. Without forethought — and forewarning to executives — decisions on compensation adjustments can create unintended consequences. The heightened emphasis on corporate social responsibility in today's environment and focus on how a company's actions affect its broader stakeholders mean that now more than ever, committees need a thoughtful process for considering discretionary adjustments.

It goes without saying that the board as a whole must regularly discuss the factors driving performance variances against budget and incentive goals. How might reality deviate from assumptions in the budget, and what is the impact on incentives? What unplanned occurrences, such as acquisitions, restructurings, external macroeconomic shocks and unforeseen government regulation, can influence results? What windfalls or shortfalls are in the making as a result of these unplanned events, and how has management responded to capitalize on tailwinds or address headwinds? What is the experience of various stakeholders, including employees, shareholders, customers and suppliers?

To keep on top of these factors and their effects on executive pay, committee members should establish a process for thorough, forthright conversations with management each quarter about business performance and corresponding incentive payouts. Are directors and executives aligned about the factors driving performance variances and how they might, in turn, affect pay? The aim of these conversations should be to develop a consistent set of expectations and, over time, a transparent, predictable process between management and the board about when and how to apply discretion. If a company has not yet developed a process for these conversations, the current economic uncertainty presents an opportune time to start having them.

The last six months showed us that even the most well-thought-out goals — with standard and automatic adjustments — can still be subverted by unexpected events. To that end, here are some factors to consider when it appears that discretionary adjustments may be warranted — both in the current environment and on an ongoing basis.

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Philosophy. Decide in advance whether you will, or will not, adjust payouts for unexpected results not covered by automatic pay-adjustment mechanisms. In this regard, be sure to view the issue holistically. Some companies will deliberately widen incentive ranges around target to account for some unexpected factors. Further, in today's plans, in which one metric is often meant to complement another, a negative impact in one area might be offset by a benefit in another. For instance, if price increases can be passed through to customers, revenue may exceed budget while inventory efficiency declines.

Annual versus long-term. Will you adjust both short- and long-term incentive payouts? Be intentional. Anticipate different causes and how you will deal with them. Foreign exchange fluctuations, for example, may call for adjustments in only the annual plan as executives often cannot be expected to counter currency gyrations in just a 12-month period. But, over the long term, it may be appropriate to hold management accountable for responding to the currency environment.

Population. Will adjustments cover all incentive plan participants or just selected people? When directors feel obligated to contemplate a punitive adjustment, limiting action to senior leadership may be appropriate to protect the broad organization.

Materiality. If results are unexpected (up or down), what is the threshold of materiality that justifies adjustment? Is a 5% shortfall, for example, material enough to make an adjustment? Or do you have to hit, say, 10%? Directors do not want to be drawn into an inefficient process of discussing, debating and making a cascade of small adjustments.

Perception. Given the possibility of negative optics, is the rationale to justify the adjustment clear and defensible? Does it align with how investors and other stakeholders will view performance? Do the adjustments balance being fair with risking unwanted scrutiny? Are adjustments consistent with the experience of other stakeholders, such as employees, customers and suppliers?

Consistency. Over time, are the adjustments being considered both positive and negative, or is there a skew one way or the other? If discretion is applied in one year, does that set a precedent for future years? How can discretion be communicated to avoid creating an expectation?

Optional compensation. What opportunities outside the regular pay program are available for adjusting pay? Spot bonuses? Special equity grants? How might you use them instead of adjustments to the formulaic incentive plans?

Over the past 10 years, many companies have moved toward a fairly standardized set of pay structures that have not been tested by an economic downturn. In our experience, most directors and executives want to live by the numbers set by these structures at the start of the year. Payouts will then rise and fall with the tide of the industry and the economy. But the current circumstances have shown that directors would be well-advised to think about whether they have the tools at their disposal to exercise discretion in a disciplined way when things go awry.

In any case, it is best not wait until the end of the year for sensitive discussions regarding pay. Better to review such issues in your ongoing board communication process, when explicitness and transparency should be the bywords. Executives will then more likely deem payouts fair and appropriate. Shareholders, having read the Compensation Discussion & Analysis, will meanwhile be less likely to disagree with the committee's judgment if the adjustments are defensible and supported by a clear rationale. And employees and the public will see exceptions as logical and justified. When you need to step in with adjustments, your action will then be no surprise to anyone. ■

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