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In Compensation Philosophy & Programs

Four Ways to Appropriately Address the Impact of COVID-19 on Executive Compensation Programs

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Businesses of all sizes in every sector of the economy are feeling the impact of COVID-19 to one degree or another. The initial economic impact COVID-19 (outside of the immediate local effects in China) was focused on multi-national corporations with large operations or supply chains in China, but the expanded reach of the disease and its expected spread has reduced economic activity across all sectors of the economy.

As the scale and severity of COVID-19 continues to expand, companies are wrestling with a host of business continuity and human resource challenges. Global pandemics are a true "black swan" for corporate activity, creating tremendous uncertainty and making business-as-usual planning irrelevant for a period of time. Executive compensation is by no means the most important current challenge facing Boards, but it is critical that the focus on pay and performance is responsive to the environment.

The timing of the outbreak at the beginning of the fiscal year for many companies, and the resulting volatility in the stock markets, has created a unique set of challenges for companies' executive compensation programs. These challenges include:

- Uncertainty about setting goals and payout ranges for incentive plans when the scope of the impact is not known
- Impact on equity awards, especially those companies making annual awards at the end of February or early March following the stock market declines
- Process and impact on in-cycle incentive cycles and performance share grants

A number of approaches exist to manage various challenges. The right approach will vary company-by-company depending on the impact of the COVID-19 on the business, the company's incentive design, and where the company is in its planning and compensation cycles. In many cases, companies have approached annual incentives and long-term performance plans differently. Below we describe the primary approaches companies have followed to address the COVID-19 on executive compensation:

1. **Establish a framework for applying discretion in assessing performance** Given uncertainty about the severity and length of the impact, many companies will want to use discretion at the end of the year on annual incentive payouts. It will be important to establish a framework up-front for how discretion will, and won't, be applied in order to ensure decisions at year end are consistent with expectations for both employees and shareholders.

2. **Track the impact on annual goals.** It will be most effective to apply discretion at year-end if there is clear visibility throughout the year about the impact. Many Boards are receiving in-depth briefing materials on the different areas where COVID-19 will impact results (e.g., revenue, inventory availability, supply chain costs, human capital risks). These conversations and resulting actions taken in response will translate into financial results. Tracking items on a regular basis and the impact on financial results will help companies exercise discretion in a thoughtful way at the end of the year.

3. **Create the right Board culture:** Companies are considering delaying grants, particularly for performance shares, to later in the year. Since most performance shares are measured over 3 year periods, a delay over a few months is more palatable for performance shares than for annual incentive awards measured over 12 months.

4. **Convert long-term incentive values using a longer average share price.** Recent stock market volatility has highlighted the challenges with converting a targeted grant date value award to a number of options or shares based on a short-term stock price. An average stock price over a longer period of time (30- or 45-days) can help avoid unintended windfalls from this year's equity awards if the stock market quickly recovers.

An effective executive compensation program incorporates individual company circumstances and balances management incentives for delivering performance within its control with return to shareholders. This balance is tested in periods of great uncertainty and negative shocks, when shareholders may experience significantly lower stock price and earnings in a period where management's effort and commitment is at its highest levels. Thoughtful exercise of judgment by the Board in interpreting performance is required to keep this balance in order. For example, a business that reduces internal forecasts and exceeds those results may consider reducing annual incentive payouts to a level that is more reasonable relative to the shareholder outcomes (e.g., at 80% or 100% of target).

By starting now, companies can lay the groundwork now for a thoughtful approach to addressing the impact on executive compensation, even while the impact of COVID-19 continues to be uncertain for the near future. ■

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