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ADVISOR BLOG

The Softening Economy and Incentive Design: A Compensation Committee Top Concern

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Many compensation committees have labored lately over incentive plan design for the obvious reason: Will the economy soften or even enter a recession this year, and how might that impact business? They are also pondering how this year is different from the past two years when the COVID and post-COVID environments created havoc with incentive plan design and goal-setting.

The answer is that, although similar in upheaval, we may have a tougher hill to climb. Institutional investors will be less tolerant of modest financial forecasts accounting for potential supply chain problems, labor and part shortages, factory shutdowns, inflation, and other factors that may impact a company's performance in 2023. Investors may feel companies have had several years to deal with these COVID-related issues, and that reliable forecasting and more dependable performance should once again be the norm.

Compensation committees can combine two tools to help create effective incentive designs in an uncertain economy: Creative goal-setting approaches and the liberal use of discretion.

Goal Setting

My colleague Matt Turner recently wrote a blog, "Small Steps to Mitigate Risk and Create Resilience in Executive Compensation Goals," where he outlines several tactics enhancing the goal-setting process:

- **Get Profit and Growth Forecasts as Right as Possible**: Understand and take into account industry and peer performance and shareholder expectations when setting forecasts.

- **Control Volatility with Incentive Plan Metrics Collars**: Collar interest rate swings, price shocks from supply chain disruptions, exchange rates, and other significant factors that may impact your financial results to avoid extreme outcomes. Management should not be unduly enriched or punished for highly uncontrollable results. Limit your adjustments to the annual incentive plan with no adjustments in the long-term plan to provide a balance.
- **Widen Incentive Plan Performance Ranges**: If the committee typically sets ranges of plus or minus 10 or 20 percent around the target, the range may need to be 30 percent or more to manage more unpredictable outcomes.
- **Use More Time-Vested Equity**: A well-designed incentive plan has a retentive effect, and in volatile times, the long-term incentive plan may need to weight time-vested equity more. We've seen companies make this change over the past few years. Shareholders and proxy advisory firms, in particular, may object. Still, senior executive turnover can be highly disruptive and impact financial performance more than a poor goal-setting approach in a wavering economy.

Financial Results Adjustments

Most committees and boards include or exclude certain items in the financial results used to determine incentive plan funding and award levels. Consider reviewing and modifying the criteria used to make these adjustments to account for changes in your business plans or strategies in an uncertain economy. Sometimes, the committee may not have written guidance covering potential financial adjustments. It is always a good idea to draft a statement with a list of potential adjustments, realizing a company can never anticipate all possible adjustments. Still, the committee and management team should discuss potential changes early in the year to avoid acrimonious year-end discussions.

Using Discretion in Tandem with a Modified Goal-Setting Approach

Compensation committees can use discretion in many ways. And discretion means encouraging the committee to exercise judgment more often, if needed, to get the right result. Combining effective goal-setting techniques with liberal use of judgment, when needed, is a powerful incentive plan design tool.

Allow for Greater Use of Discretion

Many annual incentive plans include non-financial goals. Consider including more strategic or individual goals allowing the committee to use judgment to assess performance against goals more freely. Some goals or situations that can benefit from exercising judgment include:

- Milestone goals in the annual or long-term incentive plan where progress on or the attainment of the goal is not completely measurable;

- Critical ESG goals in the incentive even if goal-setting is hampered by a lack of historic data;
- Progress on diversity, equity, and inclusion;
- Goals supporting the movement of a company's portfolio of companies from an industrial concentration to a tech orientation; and/or
- Identifying and developing the next generation of leaders.

Increase the Non-financial Goal Weight

It is not uncommon for an incentive plan to include non-financial goals with a 20% weight but there is nothing magic about this percentage. A plan could include a 30, 40, or 50% non-financial goal weight with the understanding the 40 and 50% weights are far less common. Still, this design gives committees the ability to exercise more judgment when discussing performance.

Do Shareholders and Proxy Advisor Firms Really Frown Upon Using Discretion?

The answer is clearly no, but they get cautious and skeptical if a company does not explain the factors they took into account in assessing performance using discretion. A company must disclose in the CD&A, in as much plain-English detail as possible, the factors the committee considered when evaluating performance.

Proxy advisory firms consistently ding companies for inadequate explanations when committees apply judgment. And shareholders may question why a company's incentive awards were substantial in an otherwise weak financial year. Conversely, a well-written CD&A in plain English will address many questions shareholders and proxy advisory firms will have in understanding the relationship between award levels and performance and how committees used discretion to align pay and performance.

Although committees should not constantly change plan designs or incorporate too much judgment in assessing performance, these goal-setting techniques with enhanced discretion can help committees maintain effective incentive designs that motivate, incent, and retain talent in uncertain times.

About the Author

Pete Lupo is the president of executive compensation and leads the executive and broad-based compensation consulting practices at Pearl Meyer. In this role, Pete works closely with the firm's senior leaders helping clients build innovative compensation programs that retain, motivate, and reward senior leaders and employees. Pete has worked extensively with compensation committees and management teams on a variety of strategic needs including the development of total compensation programs for the senior leadership team, aligning pay to performance, designing annual and long-term incentive plans, developing board of director pay programs, and advising on change-in-control, executive benefits, perquisites, and governance-related matters.

About Pearl Meyer

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