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managing incentives in uncertain times

How should companies address the impact of the coronavirus and the economic downturn?

As companies focus on how to protect employees and customers against the novel coronavirus (also known as COVID-19), incentive compensation isn't yet top of mind. But questions have been surfacing as compensation committees meet to set goals for performance periods beginning in 2020 and review progress against goals for outstanding long-term incentives.

Forecasting business conditions one to three years out is challenging even in stable economic times, but fears of a global pandemic and a possible recession have made it even more difficult. And recent stock price volatility could impact equity plans, including the number of shares companies grant and compliance with stock ownership guidelines.

Challenges are most acute for the travel, leisure, and consumer products industries, but the impact is expanding. It's not too early for companies in all industries to consider the potential implications and a possible recession on performance results and incentive awards.

2020 awards

Goal setting

Incentive plans are designed to align employees' rewards with company performance. When unplanned events occur that threaten that link, companies must wrestle with whether to adjust incentive awards to avoid unintended windfalls or penalties for participants.

Companies should have an established policy specifying the types of events that warrant automatic adjustments, which could include unanticipated events such as a pandemic.

Example. ROCE and Cash Flow shall be adjusted for all items of gain, loss, or expense for the fiscal year, as determined in accordance with Generally Accepted Accounting Principles, (i) from non-cash impairments; (ii) related to loss contingencies identified in the footnotes to the Company's financial statements; (iii) related to the impact of the coronavirus outbreak on the Company's operations; (iv) related to the disposal of a segment of a business; or (v) related to a change in accounting principle.

But if isolating the impact of the coronavirus isn't feasible or appropriate, companies can take several other actions.

For short- or long-term incentives:

Postpone setting performance goals for one to two months when the likely impact on performance results is clearer

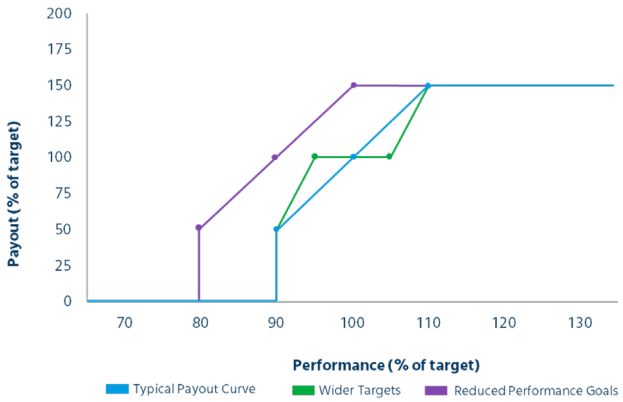
Build in **more discretion** to make adjustments to performance targets or award payouts (up or down), which is easier now that Code Section 162(m)'s performance-based pay prohibition on upward discretion no longer applies

Provide less stringent plan leverage, such as by:

Setting wider ranges for performance around target — e.g., +/– 5% of target performance yields target payout, which may mitigate goal setting challenges in volatile situations where predictions are difficult

Lowering or eliminating thresholds to help achieve a minimum payout (see illustration below) so awards where threshold performance wouldn't have been met can continue to motivate participants

Illustration. The blue line represents conventional leverage. The green line illustrates setting a wider range for performance around target (+/– 5%). The purple line illustrates lowering the performance threshold to help achieve a minimum payout, while also reducing performance levels needed to earn target and maximum payouts.



For example, if actual performance is at 95% of the original target:

- The typical payout curve **(blue)**, would pay 75% of target.
- The wider performance targets **(green)** would pay at target.
- The plan with reduced performance goals **(purple)** would pay 125% of target.

If actual performance falls below 90% of the original target, the plan with reduced performance goals (purple) would pay out, while the original plan would not.

For long-term incentives:

Use **annual performance periods** with additional service-based vesting requirements, and set goals each year rather than at the start of a multi-year award, since setting annual (vs long-term) goals is easier during times of uncertainty

Use **relative metrics**, calibrated as a percentile rank against industry peers, rather than attempting to forecast internal financial metrics, since the financial impact is likely to be similar for companies in the same industry

Place more weight on **service- or time-based awards**, which align participant interests with those of shareholders while also promoting retention

Equity grants

With the recent stock market volatility, mechanical application of value-based grant guidelines could result in significantly more shares being awarded than anticipated. This can increase dilution and burn rates, and create potential compensation windfalls if stock prices recover quickly. On the other hand, delivering less value could raise retention risks and lower the morale of plan participants.

Companies that haven't yet made their equity grants may want to consider using the average stock price over a longer-term (e.g., 90-120 days) to determine grant size. A longer-term average price could also be used to assess compliance with stock ownership guidelines.

In-progress LTI awards

The business impact of responding to the virus and a potential recession may also affect in-progress LTI awards where goals were set before the crisis began and awards may no longer be motivating to participants. It may be too early to adjust the goals on financial results. But to preserve the intended benefits of the plan, companies could:

- Add a provision to automatically exclude the impact of the coronavirus (as shown above for 2020 awards)
- Communicate to participants that discretionary adjustments will be made at the end of the performance period

Before taking any action, companies should consider the regulatory and governance considerations in the table below:

Regulatory and governance considerations	
Additional accounting expense	• For stock-based awards like performance shares, a modification to lower goals or exclude the negative impact of the virus could trigger additional accounting expense if these types of changes aren't required under the plan and are deemed discretionary • Standard plan language that excludes "unusual" or "infrequently occurring" items (accounting-defined terms) may not apply to the indirect impact of the virus or a recession (such as lost revenue), but direct costs (such as added expense of disinfecting facilities) might qualify as automatic exclusions (the determination for each company is subject to approval by its auditors)
More proxy disclosure	• Any incremental accounting expense arising from a discretionary adjustment to awards held by the named executive officers is reported in the proxy's Summary Compensation Table and Grants of Plan-based Awards Table • Adjustments should be accompanied by an explanation in the Compensation Discussion and Analysis
Negative investor and proxy adviser views	• Investors and proxy advisers favor clear connections between performance and incentive plan payouts and typically take a dim view of discretionary adjustments that benefit executives without adequate explanation but would likely be open to adjustments for an unanticipated global health crisis
Concerned employees	• Lack of specificity about items triggering adjustments may raise participant concerns about fairness

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What to do now

Based on a recent Mercer survey and discussions with our clients, most companies are taking a wait-and-see approach. Several expect to make discretionary adjustments at the end of the performance period when the effects are more fully known, while a few are postponing long-term incentive grant decisions. Companies with relative performance measures are best positioned to wait and see, since their competitors are likely to experience similar consequences.

But even companies in wait-and-see mode should take the following actions:

- Model potential scenarios as more information becomes available. In coming months, most companies will be able to estimate the financial impact on their operations.
- Review incentive plan language to determine if the impact of the virus could be excluded. Standard plan language may not allow for "automatic exclusion" from incentive plan goals or results, so companies should confirm with counsel whether their plans allow discretionary adjustments.
- Consider when, and how, to communicate the impact on incentives. Companies should be prepared to answer questions from plan participants.

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