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COVID-19 + Compensation

Preparing for Pandemic-Related Discretionary Compensation Adjustments

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COVID-19 CONSIDERATIONS

The coronavirus pandemic is likely to continue for months, and uncertainty remains high. In our companion articles on its impact for compensation, we've largely urged a "wait and see" approach for addressing previously granted and outstanding incentives. That said, now isn't a time for complacency. We recommend that Board compensation committees begin to prepare for potential discretionary adjustments at year end.

Any adjustments are likely to be controversial, but committees can minimize the sensitivity by carefully tracking, in real time, the pandemic's impact on business results and thus on incentives; and by aligning on which business impacts to consider for adjustment. It's particularly important that directors and management maintain open communication, in order to maintain trust between the two groups. Further, grounding the approach in objective criteria can serve as the foundation for robust disclosure that will reassure investors and outside stakeholders.

This article offers a framework for tracking the business impacts from Covid-19, and for laying a foundation for any pay adjustments. Discretionary adjustments should reflect a holistic view of the company's results before, through, and following the pandemic. The work is likely to be complex and time-consuming, so committees shouldn't wait. That's especially true for companies with fiscal years ending in the summer or fall.

Tracking the Impact

Boards won't know the full impact of the pandemic on their company's business results for some time yet. But they can identify metrics where the company is likely to be most vulnerable and see how their performance compares with previous years and with competitors'. At the early stages, it is important to be fairly exhaustive in the exercise, exploring first-, second-, and possibly third-order impacts.

Here's a generic example for one company:

IMPACT	MITIGATION STRATEGY	IMPACTED METRIC(S)
Slowing (or no) sales from "closed" economies	Shifting sales to web channels; "retooling" to meet changing demands	Sales
Raw material/ supply chain disruption(s) from "closed" economies	Shift to suppliers in less impacted regions	COGS, Sales
Reduced/ delayed production capacity as manufacturing partners are closed or operating at reduced capacity	Shift production to less impacted regions	COGS, Sales
Delivery delays caused by stresses to transportation network (e.g., absenteeism, prioritizing essential services/ products)	Leverage relationships with key partners; shipping visibility tools	COGS, Sales
Aged inventory from slowing sales in heavily impacted regions	Transfer goods to less impacted regions	Margin
Associate health/wellness and engagement	Active communication; enhanced safety protocols	Payroll, SG&A

Boards should then work with management to quantify the real time impacts with an aim to understanding materiality. Most boards already discuss the factors driving performance variances throughout the year. But certainly in today's environment, committee members should establish at least quarterly conversations with management about business performance, mitigation strategies, and the corresponding implications for payouts. To keep the process manageable, the focus should be on major impacts.

Engaging Early and Often

The aim of this quarterly tracking is not to establish a record for adjusting for all impacts, only to understand the full picture. As the year progresses, compensation committees will eventually need to align on what impacts they will and won't adjust for. While many companies have frameworks describing how unforeseen factors will (or won't) be accounted for, the pandemic is a large and unique enough event to warrant a separate assessment.

Through regular and consistent dialogue with management, the compensation committee can establish a game plan for whether and how to use discretion at year-end. And consistent engagement will help to minimize friction over final decisions. Executives may still be dissatisfied, but directors won't rupture relationships with their surprise use of—or decision against—discretion.

Minimizing the Fallout

Boards' decisions will eventually go public, so they will want to set a consistent and transparent set of expectations in light of the current environment and with an eye to the concerns of all stakeholders—investors, employees, customers, and the community at large.

To this end, committees (and Boards as a whole) will need to consider a variety of factors:

- **Materiality:** What is the threshold that justifies adjustment? Directors do not want to be drawn into making a cascade of small adjustments. Better to use discretion all at once.
- **Annual versus long-term:** Should boards adjust only the annual bonus, or also the long-term incentive payouts? It may be appropriate to hold management fully accountable for responding to the changed environment after 2020.
- **Population covered:** Will adjustments cover all incentive-plan participants, or just selected people? Directors may prefer adjusting results for the broader organization (in the spirit of retention and engagement) before rewarding senior executives.
- **Trajectory:** How has the company weathered the pandemic – in absolute and relative to peers? Directors may be more inclined to employ discretion if it can demonstrate that management has navigated the crisis well and the company remains on solid footing.
- **Internal/external 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 view performance? Do the adjustments balance being fair with risking unwanted scrutiny? Do the adjustments seem appropriate in light of how other stakeholders have been affected?
- **Consistency and precedent:** What is the board's past practice in making adjustments? If the Board has consistently skewed toward positive adjustments, directors may be less inclined now to make a large positive adjustment for the pandemic. Beyond 2020, how can Boards explain the use of discretion to avoid creating an expectation?

Preparation ahead of time will result in a thoughtful CD&A, grounded in a clear rationale, which in turn will make investors less likely to disagree with the committee's judgment. Employees and the public will be more likely to see exceptions as logical and justified.

This work of preparation won't be wasted. After a decade of relative stability, companies are now facing multiple forces for volatility. Future pandemics, climate change, trade wars, political shifts, and a new wave of digital technologies all have the potential to disrupt compensation programs. Greater concerns for stakeholders, the goals for which are often hard to set upfront, may also lead to greater discretion over payouts. Well beyond the end of the Covid-19 pandemic, compensation committees may want to track certain metrics related to potential discretionary adjustments. ■

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