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How Inflation Complicates the Compensation Committee's Job



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It has been a very long time since we've dealt with an inflationary economy. So long, in fact, that the term "inflation" may conjure memories of Jimmy Carter's presidential administration, long lines of AMC Pacers waiting for gasoline, and double-digit mortgage rates—for those of us who go back that far. The idea that this period of inflation may be transitory isn't much comfort to the decision-makers who are still determining their 2022 plans.

Given that most calendar-year companies approve incentive plan targets in the first quarter of the year, inflation's impact on executive pay decisions is on the minds of most compensation committee members. Of course, inflation impacts the price of goods and services almost across the board (we are all feeling that currently), but specifically for compensation decisions, there are two main variables to consider: merit budgets (or salary increases) and incentive plan goal-setting. Let's briefly explore some of the fundamental current challenges with each.

Merit Budgets and Salary Increases

For as long as most people can remember, merit budgets have been reliably steady at 3 percent per year at all levels in an organization. In the past, merit budgets tended to lag inflation rates early in inflationary periods. They may also have tended to be higher than was necessary in the waning days of an inflation cycle. Both tendencies can largely be blamed on time delays in incorporating external information into the decision-making process. The era of 3 percent increases are ending. In December, results from a Pearl Meyer quick poll suggested the number may exceed 4 percent. Some clients are concerned we may end the year above 4 percent if additional actions are required later in the year.

Because the current environment is challenged by inflation, as well as ongoing pandemic and labor difficulties, some management teams might see an increase to the merit budget for the broad workforce as perhaps one of the easier decisions to make this year. It's a

different story, however, for executives.

Boards have generally been more willing to increase incentive opportunities than to provide executives with significant salary increases. This is due to the bias toward performance-based compensation and can be seen in the evolution of executives' pay mix over the past 40 years. However, incentive plans can be perceived as riskier during inflationary times—to say nothing of the other risks looming—and so higher incentive opportunities may be less valued right now than smaller salary increases.

Every now and then, someone raises the idea of a cost-of-living adjustment (or COLA) for executives. It may seem a logical extension of a COLA for the general population, but beware—it's not. Competitive salary increases for the general workforce are important, but that standard 3 (or more) percent merit budget can usually accommodate them. COLA for executives, on the other hand, is something that investors and the public cannot understand. The perception of COLA is that it meets fundamental needs like paying rent or putting food on the table; the "need" to maintain the buying power of a $500,000 salary is not viewed in the same way.

Incentive Plan Goal-Setting

It seems as though we've been hoping forever that things will get back to normal so we can have greater certainty in our forecasting. While COVID-19 has created exceptional uncertainty, inflation just creates a "normal" amount of uncertainty (which we really don't need any more of).

Logically, one would think the key is to understand how the company's results are impacted by price changes through the supply chain and then factor in the company's ability to pass on these additional costs through corresponding product or service price increases—a seemingly simple calculation to arrive at anticipated financial results.

However, every item in the supply chain reflects a similar analysis, and supply chains are far more intricate than in previous inflation cycles, so it becomes hugely complex to predict what will happen. By upsetting pricing all the way along the supply chain, inflation introduces additional prediction risk when projecting future results. When compounded with typical executive incentive plan time frames, usually one- and three-year, the projections can become speculative.

Fortunately, understanding these dynamics is the chief financial officer's responsibility. But at the board level, we need to at least understand the subtleties to develop a feel for whether any changes might be warranted to, for example, thresholds, maximums, or gatekeeper measures in any existing or future incentive plan. This is important when determining and explaining any non-GAAP (generally accepted accounting principles) or judgmental adjustments to payouts. Regarding long-term targets, changes to the mix can be made to deal with higher goal-setting risk by incorporating more time-based stock

vesting or options and less performance-based stock, for example.

A complicating factor for directors approving annual goals is that inflation generally results in higher earnings growth than we normally see. When a company has been moving along at a steady, and perhaps more predictable, earnings growth rate of 5 to 8 percent, it is psychologically difficult to set a 15 percent goal. If demand stays strong as inflation increases, you may see companies overachieve during the early days of a cycle. Then, the opposite occurs as inflation cools, and taking earnings expectations back down to pre-inflation ranges becomes similarly difficult, especially for investors.

Plowing Ahead

In reviewing budget proposals this year, boards need to be more focused than ever on assumptions relative to the cost of goods sold and volume projections at higher product prices. Compensation committees may want to think about providing for potential year-end adjustments that reflect the differences between key assumptions and what actually happens. Many did this with volatile US dollar to Euro exchange rates a few years back.

Alternatively, committees might consider increasing the range from threshold to maximum to recognize that results will inevitably vary from assumptions given that the factors are harder to predict. In either case, explaining these changes both to participants and to shareholders will be critical.

About the Author

Mark is a consulting team leader who brings 20+ years advising on executive and board pay, including benchmarking, retirement plan design, and tax/accounting and governance considerations.

About Pearl Meyer

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