Pearl Meyer

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Small Steps to Mitigate Risk and Create Resilience in Executive Compensation Goals

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Thanks to both current and recent events of the past few years (inflation, the effects of COVID-19, the deterioration of the global supply chain), even the most thoughtful and forward-looking companies have discovered that good fundamentals do not always produce reliably appropriate performance targets and ranges for executive compensation plans. Our operating environment has become far more complicated, and the definition of executive performance has expanded beyond profit and growth, making it far more difficult to set accurate and relevant goals.

In the past, establishing an executive's incentive plan was simply based on financial matters, the company's operating plan, and its long-range forecast. In more recent years, as the focus has increasingly turned to pay for performance, many companies have enhanced the goal-setting process and incorporated additional analytics and data, including peer and industry performance history, forecasts, and models of shareholder expectations. This delivers goals that are more thoughtful and shareholder-aligned.

However, today's expectations are higher still. ESG is emerging as a compensable factor, and talent acquisition and retention at all levels presents significant enterprise risk. Those are just a few of the emerging issues that raise the stakes for executive performance and contribute to more hits and misses in incentive plan targets.

The big question is, how can companies balance the often-competing objectives of achieving good pay-for-performance alignment, and retaining and motivating people, while addressing a significantly broader scorecard of performance? The answer that many boards understand but dread: more time and effort.

While we can't cut corners, and the right combination of tactics will be different for each company, there are some baseline considerations for better efficiency that may also offer some measure of "future-proofing" your plans.

Block and Tackle

Good blocking and tackling means getting the core profit and growth forecasts as "right" as possible. Budget and planning perspectives should be reinforced with an analysis of industry and peer performance and shareholder expectations—with consideration given for company-specific context. The committee should also be engaged in goal-setting early and often.

Control for Highly Volatile Inputs

While we typically want to hold management accountable for results they control and over which they have influence, has your committee considered promoting stronger alignment by insulating short-term incentive plans from things like interest rate swings, price shocks from supply chain disruptions, exchange rates, etc.?

To accomplish this, goals are set conditionally, with formulaic adjustments occurring when key variables move outside of a planning collar. While this adds complexity, controlling incentive metrics for these inputs can lead to less volatility in incentive plan outcomes. The caution is to ensure that controlling for these inputs doesn't incent bad decision-making or absolve management from managing *the entire* business during challenging times. Limiting your adjustments to the short-term plan, with the long-term plan remaining "all in" on performance and external events, is a smart move.

Go with Wider Performance Ranges

While this may be obvious, it may be time for a recalibration reflecting actual historical and expected variances. In the past if your company has just mechanically applied ranges of plus or minus 10 or 20 percent, your operating income range may need to be plus or minus 30 percent or more.

Increase the Use of Time-Based Equity

Following every economic disruption, we have seen the mix of long-term incentive vehicles tip back toward the use of time-based equity. After a couple of years, the trend reverses and performance-based equity prevalence increases. But this time, despite ISS objections, it may be worth keeping things simple if multi-year financial goals prove too difficult to set.

In Conclusion

On top of all of this, discretion and qualitative performance evaluation is here to stay. Frankly, it's always been difficult to reduce executive performance evaluation to a formulaic assessment of profit, growth, and total shareholder return. But to do qualitative performance evaluation right—which is part of our new normal—companies should adhere to a few key principles: be prepared, consistent, fair, modest, and act with integrity.

About the Author

Matt Turner is a managing director and consulting team leader at Pearl Meyer. In his management role, he oversees a team of senior compensation consultants in the execution of the firm's growth strategy and in the development of consultants at various stages in their careers. He specializes in advising company boards and senior management on executive compensation strategy, incentive plan design, tailoring of performance measures, and the setting of shareholder-focused performance objectives.

About Pearl Meyer

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