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Addressing the Impact of COVID-19 on Performance-Based Compensation

Introduction

In just a few months of 2020, novel coronavirus (COVID-19) has permeated every aspect of business and society. Initially, it seemed like a tragic but localized health matter abroad. Then it began to reverberate through the global supply chain. Now, with outbreaks in virtually every country, COVID-19 has become a global pandemic that may be the catalyst to a global recession.

Every business discipline is asking how it can help support the smooth progression of commerce amid chaos and uncertainty. From the perspective of executive compensation, this question is particularly acute given the criticality of aligning incentives and suddenness in which performance equity metrics and goals have been turned upside down.

To be effective, performance awards need to have realistic goals so that the recipients perceive a high line of sight between their actions and their ultimate pay. COVID-19 is now making it virtually impossible to set performance goals on new long-term incentive awards and annual short-term cash plans. Most companies with calendar-year fiscal years issued their annual grants in February or March—that is, just before COVID-19 hit the global scene—leaving everyone else with the valuable opportunity to incorporate the newfound uncertainty into their metric selection and goal-setting process. But this is easier said than done.

In this article, we discuss how companies are taking COVID-19 into account when setting new performance goals. We'll cover the various alternatives that are available, then go through their implications for financial reporting and the proxy.

Goal-Setting and Goal Measurement During Economic Turbulence

All the concepts we're about to discuss hold true for outstanding equity awards whose realizable pay levels are also under threat. However, outstanding awards are trickier to deal with because modification accounting is involved. There's also the fact that shareholders don't like to see revisions to existing grants.

When setting performance goals for a new equity grant under the long-term incentive plan (LTIP) or the annual bonus plan, the central question is how the compensation committee can get comfortable with the relevance of the proposed metrics and the rigor of the proposed goals. In short, the committee will need to know why the new performance metrics fit the business and whether the goal levels are thoroughly challenging.

These questions are tougher to work through amid extreme economic uncertainty. Especially with respect to annual bonus plans, management's top priorities may have shifted from whatever was in place a few months ago toward continuity, supply chain management, liquidity, retrofitting the product mix, and employee safety. Should these sorts of metrics be used? Similarly, how should uncertainty be incorporated into goal-setting to ensure goals do not suddenly become meaningless and lose their incentive impact? Whatever happens with outstanding awards, the upcoming annual grant is vitally important to keep leaders focused on the right priorities.

Another consideration is that the impact of an economic downturn on equity compensation today will be much different from that of prior bear markets. During the dot-com bust of the early 2000s, stock options were prevalent. There was little to keep companies from repricing their stock options and taking similar measures to restore lost incentives. During the financial crisis of 2008, stock options were still in wide use, and stock option exchanges became the way many companies rebooted their incentives.

Today, performance equity is the largest component of most LTIPs. The most popular metric (roughly 60% of companies use it) is relative total shareholder return (rTSR). Relative performance metrics provide the best insulation against secular shocks.

But that still leaves 40% of companies without relative performance awards. And either way, most LTIPs consist of performance awards with three-year measurement periods, which offers less time to recover from a negative shock versus something like a 10-year stock option. There's also the fact that nearly every company maintains an annual bonus plan tied to absolute internal metrics. Finally, proxy advisors and institutional investors play a dominant role that usually curtails the range of strategies available to companies.

Depressed Equity Values Are Dangerous During Economic Turbulence

Compensation committees, CEOs, and CHROs are right to be deeply concerned today. The way executive poaching works is that competitive firms target excellent leaders in the C-suite or immediately below and approach them with a more attractive compensation package, a larger role, and an offer to buy out their unvested and outstanding equity.

When equity awards are depressed due to secular shocks that are entirely outside one's control, the cost of that buyout is low and the interest in exploring one's options is high. Key person turnover during periods of turbulence can create a negative feedback loop where setbacks beget more setbacks. That's why retention and incentive alignment are arguably even more important during troubling economic times.

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The upshot is that thoughtful formulation of the 2020 annual grant is a luxury most calendar year companies did not have as their performance goals were tied to a business plan that was locked down just before COVID-19 exploded onto the world stage. As noted in the above callout, it's important for key talent to be holding valuable unvested equity.

Annual Grant Strategies

Now that COVID-19 and extreme market uncertainty have turned business plans upside down, let's look at some solutions.

1. Do nothing and proceed according to schedule.

Argument For:	• It's simple and easy. • Performance goals already embed uncertainty; changes are not merited just because we now know the flavor of that uncertainty. • There's nothing wrong with incentive programs not paying out during troubling times, especially if shareholders are equally suffering.
Argument Against:	• Threshold, target, and stretch goals embed bounded uncertainty linked to known strategies that may under-deliver or over-deliver. Unless specifically contemplated, global shocks aren't factored into goals. • Therefore, with knowledge of a global shock underway, it's fundamentally flawed to ignore its occurrence and expected impact on the business plan driving proposed goals.

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2. Make the awards in the present but delay setting goals (e.g., by several months).

Argument For:	• It doesn't make sense to lock down goals while there is great uncertainty around the ultimate impact of the COVID-19 pandemic. • It's generally tougher to modify a goal once it's formalized.
Argument Against:	• For a large recipient base beyond the C-suite, too much delay can trigger skepticism and negative spin. • A delay in goal-setting anticipates better information in two to three months, which may very well not happen. • Depending on how the delay is done, there may not even be a service inception date (and certainly not an accounting grant date), which will alter the amortization period; consider whether the vesting date should also be deferred.

3. Defer making the awards altogether (e.g., by several months).

Argument For:	• Splitting the grant from the specification of performance goals is messy because it means the time-based awards have an earlier accounting grant date. • It's better to communicate a broad strategy of deferral due to the special situation at play and strategize around an integrated grant plan in a few months. • By pushing out the entire award, you can more easily push out the vesting date in order to require a clean three years (assuming a standard three-year vesting period) of service following the grant date.
Argument Against:	• A broad population may interpret the decision negatively—such as assuming it's a ploy to cut compensation or save money—making messaging a challenge. • Delaying the vesting to three years (assuming a standard three-year vesting period) after making the grant could be construed as heavy-handed since it functionally requires more service than normal.

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4. Reduce goals upfront by a factor in contemplation of the impact of COVID-19.

Argument For:	• It explicitly acknowledges that business operations have already been affected and attempts to reasonably incorporate those effects.
Argument Against:	• It's too much of a dart-throwing exercise; no one knows where this crisis will land. • Adjusting goals by a fixed amount may under or over-adjust, therefore creating a different problem in the future.

5. Select different performance metrics or award designs that offer better insulation against an exogenous shock like COVID-19 and any ensuing recession.

Argument For:	• It's an organic solution that gets to the root of the problem. • It's a better story for participants who are naturally concerned with the awards they're receiving.
Argument Against:	• It's a potentially drastic decision in a relatively short amount of time. • It may change the underlying incentives employees are accustomed to.

6. Set goals using the best available information and softly communicate a willingness to modify goals based on how COVID-19's ramifications unfold.

Argument For:	• It allows the compensation strategy to unfold as planned in the short term while providing assurance that the "black swan" event of 2020 is being monitored and considered. • When and if an adjustment is applied, it will be based on better information than what's available today.
Argument Against:	• When and if such an adjustment is made, it will constitute a modification under ASC 718 with incremental cost. • It assumes that an objective method will exist to quantify the impact of COVID-19 when determining how to modify goals.

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7. Draft performance goals to give the compensation committee discretion to adjust actual results based on the identifiable impact of COVID-19.

Argument For:	• It sends a clear message to participants that they won't be harmed as a result of a secular shock that's outside their control.
Argument Against:	• It will most likely trigger a deferred accounting grant date. • It assumes that an objective method will exist to quantify the impact of COVID-19 when determining how to modify goals.

Our recommendations depend on the context, but in general we're skeptical of a "do nothing" strategy. Depending on the timing of any upcoming grant, delay may be the best solution.

Otherwise, we strongly favor efforts to immunize awards from exogenous shocks via the use of performance metrics. If that's either impossible or inadequate, we're cautiously open to introducing either the fifth framework (being prepared to modify goals in the future) or the sixth (adding discretion today).

Accounting Implications of Bold Actions

Some actions on new 2020 awards may require the compensation committee to commit to making a modification in the future, such as proceeding with a grant in the present along with a soft commitment to modify the goals once the full impact of COVID-19 is understood. Here's a brief primer on how that could work out. (For modifications of outstanding equity awards, see our issue brief for details on the accounting implications.)

Modification Varieties

In an economic downturn, modifications can do any of the following:

- **Adjust the performance target.** In the simplest form, an EBITDA or ROIC target at a particular level is decreased by, let's say, 20% in contemplation of the impact of COVID-19. Another version of this approach could be to adjust report results in light of the disruption posed by COVID-19. Flavors of these modifications are the most common in practice.

- **Extend the time to achieve a target.** Although not particularly common, one approach is to allow an extra six months or year to achieve a target in recognition of how COVID-19 disrupted the global economy. An especially practical version of this approach shows up

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with stock options when terminating executives, but we expect some compensation committees to consider elongating the period to achieve a target.

- **Replace the award with something else.** This is less likely to apply to any new grant decisions, so it's worth noting as a potential response to rash action. A classic example is an option exchange, which replaces a bundle of underwater options with a smaller quantity of at-the-money options or restricted stock. Another approach we expect to see is replacing performance share units that have an absolute metric with comparable awards that have a relative metric. One benefit to the replacement strategy: additional control over how much incremental cost is incurred.

All of these actions are considered modifications under ASC 718 because they revise award terms and conditions in a way that increases the value or alters the timing of vesting.

Accounting for a Modification

ASC 718 modification accounting involves a test to see whether the modification creates incremental cost that should be recognized in addition to the upfront grant-date fair value. In a down market, modifications to reset performance targets not on track to be achieved typically constitute a Type III, improbable-to-probable modification. This means a series of metrics once deemed improbable are adjusted so that hitting them is now (in accounting parlance) probable. It's equally possible for there to be both a Type III modification for a portion of the award that wasn't expected to be earned and a Type I, probable-to-probable modification for a portion that was expected to be earned.

Proxy Implications of a Modification

Under Regulation S-K, the incremental cost associated with a modification hits the proxy tables in the year of modification. The idea is that the award that was originally granted to the employee has lost value and the modification is not economically different from simply issuing a new award. It's a matter of form and not function that this is done by revising the original award, perhaps even by maintaining the same grant ID in the stock administration system. The incremental cost shows up in the Summary Compensation Table and Grants of Plan Based Awards Table.

The impact of Type III modifications in the proxy can be counterintuitive. In financial reporting, a Type III modification often entails a true-down of expense as the original targets get classified as improbable and the fair value of the modified award is lower than what initially was set up on the original award. However, a Type III modification is by its nature a cancellation and re-grant of the award. That means the new value hits the proxy and there's no mechanism to reflect the true-down in cost that otherwise takes place in the financials.

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Modifications are extremely complex given the near-infinite possibilities and the nuances of accounting for them. This is especially true for awards with market and/or performance conditions. Please consult our modifications white paper or contact us about your specific considerations.

Compensation Committee Discretion to Adjust Goals

There's another overarching approach to dealing with broken incentives. This one involves giving the compensation committee formal discretion to adjust performance results in order to exclude or minimize the effect of COVID-19. This of course only works on new grants, since any action taken on an outstanding award is automatically a modification. If instituted on a new grant, the idea is that when the committee does exercise discretion, it's not modifying the award because it's operating in a manner consistent with upfront specifications.

On its face, adding discretion related to COVID-19 may seem no different from the standard language that allows compensation committees to adjust performance results for accounting standard changes and corporate transactions. However, broad discretion that doesn't offer prescriptive adjustments is far more likely to result in a deferred accounting grant date and therefore mark-to-market accounting.

ASC 718 provides five criteria to establish an accounting grant date, and only once there is an accounting grant date can there be fixed accounting. An award that's issued and has required service but no accounting grant date is marked-to-market until the grant date occurs. This is generally problematic because it means the actual cost of the awards granted is unknown. It depends on how the value fluctuates over the period leading up to the specification of an accounting grant date, which is when the discretion ultimately is exercised and put to rest.

It's possible to add language giving the compensation committee open-ended discretion to adjust goals due to COVID-19 events. But we think it won't meet the ASC 718 criteria for a grant date. It violates the clause stating there must be a mutual understanding of the award's key terms and conditions in order to have a grant date. The performance targets that an employee is being asked to sign up for may be materially different by the end of the performance period, and it's unclear how—or to what extent—the targets will be changed due to the subjective discretion afforded to the committee.

Before dismissing this alternative, though, consider the silver lining. For one, if stock prices continue to stumble, then the mark-to-market accounting will actually be favorable to the financial statements as fair values decrease. Additionally, if the discretion is only present for a small batch of awards to executives, then the total impact may not be overly material even if stock prices soar and result in additional financial statement charges. In short, don't be too quick to conclude that mark-to-market accounting is unacceptable. Potential volatility and complexity are merely important considerations.

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What to Do Now

The upheaval to peoples' lives, and the economies they live in, has already reached catastrophic levels. None of us knows what the future has in store. Perhaps Covid-19 will prove to be nothing more than a "pause button" on commerce, one that vacuums revenue and profit out of the economy for two months before things resume as normal. Then again, perhaps it will be the catalyst that sends the world economy into its next recession and bear market.

After preserving the safety of our families, friends, colleagues, and business partners, the next imperative is to help our economic system continue. We believe that equity compensation is a critical component of the global commercial model because it aligns incentives, helps retain top talent, and supports innovation.

Outstanding equity awards may become the main focus if the economic downturn worsens. That said, companies that have an annual grant decision in front of them have a unique opportunity to measure twice and cut once in light of the emerging new normal.

In closing, we recommend you do the following with respect to upcoming annual grant decisions:

1. Consider delaying the grant, especially if it's scheduled in the near future. However, be careful not to delay indefinitely or without considerable communication.

2. Strongly consider introducing relative performance metrics. While imperfect for their own reasons, they provide some of the best defense against economic turbulence and exogenous shocks.

3. Educate your compensation committee on the implications of exercising discretion and modifying goals. As the saying goes, it's hard to put the genie back in the bottle. While discretion and goal modifications are perfectly valid strategies, committee members may not fully appreciate the downstream implications.

4. Model scenarios so that you can educate stakeholders of how realizable pay levels and financial reporting could shift in response to changing market dynamics.

5. Discuss future annual grant decisions in the context of what's happening to your outstanding equity awards.

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We began discussing the possibility of a global recession about a year ago. Although nobody knows how big a shock COVID-19 will be, its ripples will undoubtedly cascade through the economy. We're happy to speak with you about any of the topics in this blog post. Meanwhile, stay educated and—above all—stay safe.

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