PERFORMANCE EVALUATION FOR 2020: WHERE TO START?

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The fact that 2020 has been an unprecedented and challenging year is stating the obvious. Management teams have been working harder than ever to sustain their operations and support the well-being of employees, customers, and society at-large. However, there is no avoiding the reality that for many companies, financial and shareholder outcomes for this year will fall short of initial expectations, and in some cases quite significantly. For other companies, the pandemic has provided an economic windfall as demand for their products or services has surged.

So, what are Boards to do? As we approach year-end meetings, Boards and Compensation Committees are preparing for potentially challenging discussions related to corporate and individual performance for the year, and how this performance is valued in incentive plan outcomes.

This article provides a framework of four questions for Boards to think through the year's performance results and whether it is appropriately reflected in year-end pay outcomes:

- What are the principles the Board will use in evaluating performance for the year?
- What is the process the Board will follow in evaluating performance for the year?
- How should the Board engage with the CEO on assessing the Company's performance and the CEO's own performance?
- How will a Board know it has made the right decision?

This framework is the first step in determining whether any discretion, either positive or negative should be applied to year-end incentive plan outcomes.

What are the *principles* the Board will use in evaluating performance for the year?

In most cases, the Board's typical performance evaluation approach will not be practical for 2020. For companies with well-defined performance evaluation frameworks and processes, the existing structures may not be flexible enough to capture the complex implications of the COVID crisis. The disconnect between the efforts of Management and the corporate results will have many Boards questioning how the evaluation of 2020 performance should be reflected in compensation outcomes for management teams.

To-date, most Boards and Compensation Committees have adopted a "wait and see" approach to 2020 incentive plan outcomes and have not applied discretion mid-cycle. That said, many Boards and Compensation Committees have expressed that they will consider applying discretion to compensation outcomes for the year closer to year-end.[1] This discretion might be applied to the corporate scorecard for the annual bonus (or to specific measures therein) or to the assessment of executive performance as measured in the "individual" portions of incentive plans (typically annual bonuses). Discretion could be used to increase or decrease the calculated incentive plan outcomes, based on the Board's overall assessment of performance and in some cases affordability.

In approaching these challenging performance evaluation and compensation decision-making meetings for 2020, we suggest Boards and Compensation Committees develop principles that reflect both the Board's underlying compensation philosophy and the organization's culture.

As a starting point, Boards may consider the following questions, which can help establish principles for decision-making, and should be tailored to the specific circumstances at each company:

What are the mission-critical priorities for the organization?

- These may have been part of the strategic plan and incentive plan framework prior to the onset of COVID, or they may have arisen because of the pandemic
- To the extent that these priorities are not reflected in executives' goals for the year, they could be explicitly considered as a basis for evaluation of performance in the year

How has the COVID crisis impacted Company performance and the shareholder and stakeholder experience?

- What impact has the crisis had on key financial and operational metrics that are tracked by the organization, including the mission-critical priorities referenced above?
- How material are these impacts, and what is the expected duration? Are there any large one-time items that may impact key metrics (e.g., profitability) that should be discussed?
- How well did the management team pivot to respond to the crisis?
- What is the overall shareholder and stakeholder experience for the year?
    - On an absolute basis, how is 2020 tracking relative to shareholders' expectations at the beginning of the fiscal year?

   - How has the COVID crisis impacted key company stakeholders (e.g., customers, suppliers, employees, communities, media, etc.)?

- Are there any "non-COVID" performance events (one-time or systemic) that may have also impacted performance this year?

What are the executive talent retention and motivation needs?

- Although bonuses are variable compensation, at some companies there may be a need to manage expectations for bonus payouts at a certain level

- Evaluate the retention risk and ability to motivate performance if senior Management receive a smaller than normal bonus despite the extra efforts required to sustain the company

- Retention and motivation of top talent is important, but so is maintaining the pay for performance link – this is never an easy balance, and will be particularly challenging this year

How should incentive plans reflect these factors?

- How should incentive plans and performance assessments reflect shorter-term COVID-related impacts (both positive and negative) vs. longer-term systemic performance issues (including those which may have been caused by the COVID crisis – e.g., airlines)

- Consider the affordability and financial position of the company: bonuses may be lower if company performance falls short of expectations, and affordability may constrain the ability to take discretionary actions

- Evaluate whether incentive plans and the specific metrics therein are working as intended: is there a continued strong link between pay and performance? Does the calculated result reflect the Board's overall assessment of Company and individual performance?

- Consider shareholder and stakeholder sensitivities to executive pay outcomes, particularly in the context of challenging economic conditions and increased discussion around income disparities

When should you apply discretion if it is deemed appropriate?

- In many instances, "letting the chips fall where they fall" may be the right answer for 2020 incentive plan outcomes; however, it is likely that the topic of discretion will arise at year-end Board meetings (even if the decision is ultimately made not to apply it)

- There are few precedents or guidelines on the best time to apply discretion during these unusual times (mid-cycle vs. year-end), however waiting until year-end provides the benefit of understanding the full picture of performance for the year before deciding

- Boards should minimize the number of times discretion is applied: if discretion is applied mid-year, it may be less acceptable to apply discretion again at year end if the mid-year adjustment did not result in the desired outcome

What is the *process* the Board will follow in evaluating performance for the year?

Once the Board has had initial conversations and is aligned around the principles that will be used to evaluate performance and make compensation decisions, the next step will be to agree upon the process that will be used leading up to year end.

We offer the following initial steps for consideration in *evaluating performance*:

For late Q3 and early Q4 meetings:
• Start a candid conversation at the Board level – has the organization exceeded or missed expectations in responding to the challenges arising from the pandemic?
• Discuss and clarify the information the Board will need from the CEO and the management team in order to make fully informed decisions related to Company performance (e.g., specific financial or performance analysis that the Board would like to review outside of the typical reports prepared at year-end)
• Discuss how Management has executed on shifting priorities and the strategic challenges caused by COVID
• Communicate to senior management the principles the Board will use to assess performance
For late Q4 and Q1 meetings:
• With greater clarity as to how FY2020 results landed, assess Company and executive performance using the principles agreed to by the Board

We offer the following initial steps for consideration in *assessing incentive plan outcomes*:

For late Q3 and early Q4 meetings:
• Consider if some of the metrics in the incentive plans have increased importance in consideration of the pandemic – how has Management pivoted to focus on these metrics?
• Consider market/analyst sentiments regarding performance, and the overall shareholder experience vs. expectations at the beginning of 2020
• Review the in-flight incentive plans (short- and long-term) and consider which components have been directly impacted by COVID vs. other company performance issues ○ Stress test potential outcomes for incentive plans to ensure the Board understands the potential payouts and implications under various Company performance scenarios

For late Q4 and Q1 meetings:

- Measure incentive plan outcomes and assess the appropriateness of calculated results based on the Board's overall assessment of performance

- If a material disconnect between calculated outcomes and performance is perceived, the Board may consider whether discretion (upward or downward) should be applied, including:
  - How (e.g., to the overall score, or to specific measures therein)
  - For whom (e.g., more favourable outcomes for broader employee base vs. senior executives?)
  - How other stakeholder perspectives should be considered
  - How the decision will be disclosed

- If applying discretion to incentive plan outcomes, these decisions should be made with reference to overall Company performance for the year, and how this compares to initial expectations for 2020 and relative to industry peers' performance

- The Board will need to consider the experience of other stakeholders, including shareholders and broad-based employees
  - Executives often have a higher portion of their pay tied to company performance as measured by corporate scorecard results and, as such, a discretionary adjustment to the corporate score may disproportionately impact Management relative to the general employee base

- Draft proxy circular disclosure contemporaneously, and engage with key stakeholders early
  - While it is unclear at this time exactly how proxy advisors and institutional shareholders will evaluate the use of discretion in 2020, they will certainly be seeking clear disclosure of the Board's rationale for doing so
    - Disclosure should provide an enhanced narrative of the Board's assessment of Company performance for the year (e.g., principles, process, and analysis conducted) and the resulting pay decisions
  - We expect increased director-led engagement with shareholders and proxy advisors this fall as companies look for feedback on their intended compensation approach
  - Directors will also engage with their peers, both within and outside of their specific industries to gauge the expected approach taken by other companies

How should the Board *engage* with the CEO on assessing the Company's performance, and the CEO's performance?

Particularly for 2020, performance discussions should occur between the Board and the CEO **early and often**. Establishing the principles and processes referenced above should be done collaboratively with the CEO to agree on assessment approaches, and to provide the CEO with clarity as to the Board's intended approach to evaluating performance. This will allow the CEO to align the broader team around this shared view of performance for the balance of the year. The amount of information shared with the CEO may be dependent on the relationship between the CEO and Board: where there is a strong relationship, the process to engage and collaborate with the CEO is much more effective.

Some practices to consider when engaging the CEO on *evaluating performance* include:

- "Front-end load" conversations related to evaluating performance and compensation decisions for the year; if the process and principles are agreed early in the cycle, it can help facilitate smoother discussions at year-end once results are known
- The Board should develop its own independent perspective on the CEO's performance before it considers the CEO's self-assessment

Some practices to consider in engaging the CEO on *assessing incentive plan outcomes* include:

- Self assessment for the CEO and assessments for the balance of the management team: the process should be similar to other years, but assessments may be more tied to ability to manage the organization through the crisis and ability to pivot in response to the pandemic
- Iterative discussions between the Board and the CEO to reconcile any differences in these assessments vs. the Board's view of the CEO's and other executives' performance

How will Boards *know they made the right decision?*

2020 has already proven to be a test of Board and management courage. In making year-end decisions related to 2020 performance, Boards will continue to be challenged to do the work, rely on sound process, and effectively communicate with their CEOs and management teams.

In evaluating alternatives and making pay decisions, Boards may wish to consider whether particular actions would pass the "town hall test": could the Board confidently communicate this decision and rationale to a room full of customers, shareholders, director peers, and members of the non-management employee base?

There are no obvious right or wrong decisions. Outcomes should be highly tailored to a specific organization's performance, management team, stakeholders, and circumstances, while being mindful of effectively balancing the needs to both motivate and retain high calibre executive talent and align pay with performance. Boards will, however, improve the quality of their 2020 performance appraisal and compensation decisions if they follow a robust process built upon well thought through principles.

References

[1] Hugessen Article: COVID-19 Director Pulse Survey (Summer 2020)