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EXEQUITY

Independent Board and Management Advisors

Client Briefing

One Approach to Making Your 2020 Bonus Plan Work

2020 will forever be remembered as the year of COVID-19. While the long-term economic effects of this global pandemic will not be fully known for some time, the near-term impacts on many companies, their workforces, and their pay programs are undeniable. Many companies have acted swiftly and decisively in executing immediate and direct cost containment initiatives such as layoffs, furloughs, and pay reductions, as detailed in Exequity's April 2 *Client Alert*, "*How COVID-19 Is Impacting Pay*" (https://www.exqty.com/newsroom/how-covid-19-is-impacting-pay). Meanwhile, business forecasts, operating budgets, and incentive plan performance frameworks established merely weeks ago have suddenly been rendered meaningless.

Or have they?

Looking ahead to year-end pay decisions, companies are already grappling with how to properly evaluate the uncertain impact of new operating realities that were unanticipated when incentive plan performance goals were established earlier this year. Appropriately sensitive to the perspectives of both shareholders and employees, most companies are not currently considering adjusting incentive plan performance goals. Even in the unlikely event outright adjustments would be deemed appropriate, most organizations do not yet have enough information to do so. On that basis, many companies are taking a "wait and see" approach, and plan to defer deliberations related to the assessment of incentive plan performance goals to the year-end review process. As Exequity observed in our April 8 *Client Briefing*, "*A Framework for Discretion*" (https://www.exqty.com/newsroom/a-framework-for-discretion), we expect that for many companies, incentive plan performance assessment is likely to include the application of backward-looking discretion, informed by a comprehensive review of a variety of quantitative and qualitative factors.

However, many companies will likely be uncomfortable with both the ambiguity of an undefined and arbitrary "discretionary" review process, and the well-established negative connotations associated with the exercise of discretion in setting pay. As a result, many companies will be looking for well-reasoned, easily articulated approaches to applying discretion. For that purpose, Exequity offers one example of the type of analytical approach that companies may consider in evaluating 2020 performance while maintaining pre-COVID-19 performance frameworks.

One Analytical Approach to Applying Discretion in 2020 Annual Bonus Assessment

"Extraordinary and non-recurring" events are circumstances under which discretion has commonly been applied and broadly accepted as a credible approach to adjusting incentive plan metrics. The critical element to such an adjustment is the ability to quantify the impact of the extraordinary event. Unfortunately, this is likely to be an extremely difficult task as it relates to COVID-19. However, as difficult as it may be for many companies to explicitly quantify the shock on 2020 financial results, it may be possible for some companies to isolate the impact of the pandemic for 2020 annual bonus plan assessments, as illustrated below.

A Sample Pre-COVID-19 Bonus Plan

The table below summarizes a sample bonus plan design, assuming a single metric and a common pay-for-performance framework.

EBITDA Performance		Payout as % of Target
Threshold (80%)	$400M	50%
Target (100%)	$500M	100%
Maximum (120%)	$600M	200%
Assumed 2020 Actual	**$330M**	**0%**

As we expect to see with many companies in 2020, driven largely by the economic impact of COVID-19, performance results ($330M in EBITDA, below the $400M performance threshold) indicate that no bonuses would be earned under this plan.

A Refined Approach That Could Be Applied for the Purposes of Discretion

However, a slightly different application of the same general performance framework, without the need for any arbitrary year-end adjustments to EBITDA performance outcomes or to the original EBITDA goals, could be applied in a way that could help inform the application of discretion. This model effectively parses goal-setting into shorter cycles, and is conceptually similar to approaches taken by companies that have adopted quarterly or semi-annual bonus plans—or have broken down long-term performance plan goals into an accumulation of annual goals—to address the unpredictability of longer-term goals.

Specifically, the table below breaks out the annual EBITDA performance assessment detailed above into quarterly components. Performance would then be assessed each quarter, and the results of each quarter's "funding" would then be averaged together to determine an annual payout, as follows:

Annual EBITDA Performance Broken into Quarterly Components						Payout as % of Target
	Q1	Q2	Q3	Q4	Totals	
Threshold (80%)	$104M	$96M	$88M	$112M	$400M	80% each Q
Target (100%)	$130M	$120M	$110M	$140M	$500M	100% each Q
Maximum (120%)	$156M	$144M	$132M	$168M	$600M	200% each Q
Assumed Actual	**$130M**	**$30M**	**$30M**	**$140M**	**$330M**	
Quarterly "Funding"	**100%**	**0%**	**0%**	**100%**	**Average 4 Qs**	**50%**

Clearly, the degree to which this approach is feasible is dependent upon the company's ability to parse annual performance goals into relevant quarterly components. To the extent possible, this approach assumes that the annual performance goal (divided into its quarterly components) is not adjusted from the original plan, but rather segmented into discrete periods. The upside of this approach is that the impacts of the Q2 and Q3 performance dips are isolated from Q1 and Q4 performance, which are not as heavily impacted by the pandemic in this example. The 0% funding for each of Q2 and Q3 merely factors in a four-quarter average and does not crater the cumulative annual plan, resulting in a potential payout of 50% of target rather than a zero payout. One downside to this approach would be the perception that incentive plan participants are being at least partly, and perhaps inappropriately, insulated from the impact of the pandemic on operating results. Another downside is that the impact on each of Q2 and Q3 was so significant that a potential bonus pool may not be sufficiently funded.

Conclusions

Acknowledging that there is not likely to be a generally accepted "best practice" for determining 2020 annual bonus awards, many companies will be seeking creative methods for appropriately rewarding employee performance in a year of unprecedented volatility and uncertainty. To the extent that business performance has generally recovered by Q1 2021, most employees are back to work, and a large portion of lost shareholder value has been restored, incentive plan analytics that are able to somehow isolate or exclude the impact of COVID-19 on financial/operational results are likely be deemed to be both logical and reasonable approaches to applying discretion. As always, it will be critical for companies to clearly articulate the rationale for such approaches in executive compensation-related disclosures, and to ensure that pay decisions properly balance considerations related to rewarding employee performance and aligning with shareholder interests.

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