Executive Compensation

Aligning Goals When the Future Is Not So Rosy

By Dayna Harris

The say-on-pay provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act focused attention on egregious executive pay practices in 2011 and 2012, on peer group selection in 2013, and on performance measures last year. Today, goal setting is the last frontier where investors expect companies to demonstrate that they have sufficiently rigorous goals. What should a company do when it finds itself in the unenviable position of target goals that are lower (and potentially easier) than last year's targets or actual results? The answer is a four-step process with the overall objective of being fair to both management and shareholders.

Step 1: Determine if new lower goals are truly lower. Goal setting is not simply a quantitative exercise. Goals that appear lower at first glance might not truly be lower and "easier" when specific factors are considered. This is especially true when there are sudden, material disruptors outside of management's control, or material, board-approved acquisitions or divestitures. Comparing the new goals to prior-year goals and actual results on an apples-to-apples basis will make it easier to see whether the new lower goals are truly lower and easier.

For example, an unanticipated, material change in foreign exchange rates for a global company could result in new goals that look lower than the prior year's goals or actual results. If the exchange rate used for new target goals had been used for the prior year's goals and/or actual results, then the apples-to-apples comparison could show that the new goals are not truly lower, but actually higher.

Similarly, material, board-approved acquisitions and divestitures may make goals lower than the prior year. In one case, an acquired business may have inherently lower margins but be strategically important to the company over the long run (e.g., it provides entry to new markets). This could lower the overall company goals in the short term, with the true benefit realized later. In another case, an acquired business may have lower margins or returns due to problems that the company plans to fix over the next two to three years.

In all these instances, an apples-to-apples analysis will reveal if the new goals are truly lower. If not, the company can go directly to Step 4, "Clear Disclosure in the Compensation Discussion & Analysis (CD&A)."

Step 2: Analyze the low performance. If, however, lower goals are due to a decrease in performance, then the company needs to determine the magnitude of the change and its underlying cause. The magnitude is the degree to which the goals are lower, and whether the new target goal for earnings growth is below the prior year actual result, target goal, or even the threshold goal. The underlying cause could be a broad industry or general economic downturn, where all peers face similar challenges, or company-specific declining performance for which management is more directly responsible. A comparison of recent company performance to recent peer and longer-term company and peer performance can facilitate an understanding of the cause and potential degree of concern (e.g., is the company at the bottom quartile, or moving toward the median after several years of top quartile performance?).

Step 3: Alternative solutions when goals are truly lower. If goals are truly lower due to declining performance (either company-specific or the result of an industry or economic downturn), the board's compensation committee needs to take action to ensure that new goals and corresponding payouts are fair to management and to shareholders. Insisting on unrealistic goals that are clearly unachievable may demotivate and demoralize the people who are responsible for making things better.

On the other hand, establishing realistic goals while paying a target short-term incentive (STI) for performance close to last year's threshold, or a maximum STI for performance close to last year's target, is unfair to shareholders, especially if the lower performance and goals have resulted from past management actions.

Step 4: Clear disclosure in the CD&A. Once the fiscal year is over, the achievement of goals is known, and the payouts are determined, the company will need to provide clear and complete disclosure in the CD&A about the goals, the goal-setting process, and the payout determinations. If the goals are *not* truly lower (as determined in step 1), the company should include a table illustrating this, along with a sufficient explanation.

If the goals truly are lower, the company needs to explain why, and then strongly consider including an overview of industry dynamics, peer-relative performance comparisons, and underlying long-term strategic priorities. Further, the explanation should show how the company finalized the payout decisions to ensure they were also fair to shareholders.

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The example below illustrates how four alternative solutions can serve as a guide to compensation committees. With Alternatives A, B, and C, participants know in advance what their payouts will be, but broader factors will not be taken into account. On the other hand, with Alternative D, participants don't know what the payouts will be, but the compensation committee will be able to consider broader circumstances when making the decision to adjust payouts to a more appropriate level for the performance achieved.

■ Base Case Change ■ Effective Change

Illustrative Example – Base Case* for Alternatives

	Earnings Goals		Payouts	
	% of Target	$MM	% of Target	$000s
Maximum	115%	$230	200%	$1000
Target	100%	$200	100%	$500
Threshold	85%	$170	50%	$250
<Threshold		<$170		$0

- Goals are lower than prior year
- Payouts are the same as prior year

*Base Case = hypothetical goals and payouts

Alternative A: Decrease Target Payout

	Earnings Goals		Payouts	
	% of Target	$MM	% of Target	$000s
Maximum	115%	$230	200%	$800
Target	100%	$200	100%	$400
Threshold	85%	$170	50%	$200
<Threshold		<$170		$0

This alternative reduces the overall payouts for the lower base case goals while maintaining the same performance goal and payout leverage.

- Keeps goals the same as base case (lower than prior year)
- Temporarily lowers target dollar payout
- Effectively lowers threshold and maximum payouts

Alternative B: Decrease Threshold and Maximum Payouts as a Percentage of Target Payout

	Earnings Goals		Payouts	
	% of Target	$MM	% of Target	$000s
Maximum	115%	$230	150%	$750
Target	100%	$200	100%	$500
Threshold	85%	$170	25%	$125
<Threshold		<$170		$0

This alternative reduces the threshold and maximum payouts for the lower base case goals.

- Keeps goals the same as base case (lower than prior year)
- Keeps same target dollar payout for performance below prior year
- Lowers threshold and maximum payouts as a percentage of target payout
- Effectively lowers threshold and maximum dollar payouts

Alternative C: Increase Threshold and Maximum Goals as Percentage of Target Goal

	Earnings Goals		Payouts	
	% of Target	$MM	% of Target	$000s
Maximum	120%	$240	200%	$1000
Target	100%	$200	100%	$500
Threshold	90%	$180	50%	$250
<Threshold		<$180		$0

This alternative requires higher performance to get a threshold payment or above-target to maximum payout, while keeping payouts and payout leverage the same.

- Keeps payouts the same as base case
- Keeps target dollar payout the same as base case payout
- Increases threshold and maximum performance goals as a percentage of target goal
- Effectively increases threshold and maximum performance goals

Alternative D: Use Downward Discretion at Year End

	Earnings Goals		Payouts	
	% of Target	$MM	% of Target	$000s
Maximum	115%	$230	200%	$1000
Target	100%	$200	100%	$500
Threshold	85%	$170	50%	$250
<Threshold		<$170		$0

This alternative lets the compensation committee use judgment to reduce payments to a level it considers reasonable and appropriate in light of the lowered goals, the actual performance achieved, and other circumstances (e.g., company operating environment, absolute and relative stock price performance, shareholder value recovered/increased).

- Makes no changes to the incentive structure
- Keeps goals the same as base case (lower than prior year)
- Keeps payouts the same as base case
- Allows compensation committee to exercise downward discretion to bring actual payouts in line with overall company results and situational factors D