Using Discretion Effectively in Your Annual Incentive Plan

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Historically, many annual incentive plans have been formulaic in nature, where leaders set goals and establish a pay scale. A straightforward mathematical calculation determines the level of payout according to the plan. For many companies, however, 2020 revealed the challenges of purely formulaic plans. Performance goals established in early 2020 relied on many assumptions. These assumptions proved to be inaccurate given 2020's volatility, resulting in payout amounts that were not necessarily reflective of performance.

Many of Meridian's clients are considering incorporating some level of discretion in their compensation plans. Discretion refers to a compensation committee's ability to determine a portion of payout based on qualitative judgments in addition to typical annual incentive plan markers like financial performance.

Discretion can be a valuable tool for compensation committees to ensure payouts are aligned with the organization's performance and strategic goals. There are some fears that discretion could allow committees to offer unjustifiable payouts, but a well-structured annual incentive plan allows committee members to leverage data to guide their decisions.

What are the advantages of including discretion in an annual incentive plan?

One significant advantage to including discretion is that it empowers the compensation committee to take a more holistic view of performance. Rather than evaluating what was achieved, discretion allows committees to also consider *how* things were achieved.

For example, some long-term strategic goals and priorities are not necessarily suited for formulaic financial performance measures. Discretion allows committees flexibility to assess progress against these goals. This can include ESG priorities where it may be more challenging to set formulaic objectives.

Another advantage is that discretion acknowledges that goals are imperfect. Every goal set in January or February 2020 relied on assumptions that drastically changed over the year. Volatility and uncertainty are difficult to account for when goals are set. While it would not be appropriate to completely ignore the impact of the external environment on performance results, discretion in annual plans allows for some flexibility in compensation based on what happened during the year.

What are some disadvantages?

Given the qualitative nature of discretion, it can create a level of uncertainty for executives and the board of directors as there is no neutral mathematical formula that determines the payout. As a result, discretion requires trust—executives must trust that the Compensation Committee will come to the right decision, and the directors must trust that the information they are receiving from management is complete and be willing to use their business judgment to make decisions.

Additionally, proxy advisors, ISS, and Glass Lewis have gone on record to say they do not like the use of discretion in incentive plans. Companies that use discretion in their plans are more at risk of getting pressured on Say-on-Pay votes, depending on how proxy advisors view the alignment of pay and performance resulting from the Committee's decisions.

What are different approaches to using discretion in annual incentive plans?

There are three primary ways that companies incorporate discretion into annual incentive plans: full discretion, discretion as a weighted component, and discretion as a modifier. There is no “correct” choice—which model will work best is dependent on the specific circumstances of each company.

- **Full Discretion:** In this model, 100% of an executive’s annual incentive is discretionary. At the end of the year, compensation committees evaluate performance results holistically. These plans typically have an established structure to guide decisions including performance measures and goals, but the Committee has full discretion to determine the final payout.

- **Weighted Component:** This approach specifies that a certain percentage of the incentive payout will be determined formulaically, and the remaining percentage is discretionary. For example, 70% of an executive’s payout could be based on formulaic goals while 30% is based on a discretionary assessment against key priorities.

- **Modifier:** Plans with modifiers use a formulaic plan to create an initial payout level but specify that the Compensation Committee can use its qualitative judgment to modify the payout based on established criteria.

How can discretion be used effectively?

Although qualitative, holistic judgment is a defining characteristic of discretion, it must be backed by a strong structure. At the beginning of the year, the Committee and management must establish the parameters of the discretionary component of the plan, such as key criteria for evaluation and performance objectives. Stakeholders should also proactively revisit the plan throughout the year to discuss performance relative to the established criteria. Conversations about what year-to-date performance might mean for payout levels should begin before the year ends. By having these conversations throughout the year, executives and the Committee have a better perspective on what the final payout should be.

Executive payouts are publicly disclosed, so compensation committees must be aware of how their decisions might be perceived. An organization’s internal employees will form opinions around compensation decisions relative to their view of the year’s performance and their own compensation. Externally, shareholders and proxy advisory firms will evaluate payouts based on whether the amount aligns with their understanding of performance.

For plans that include discretion, what are the disclosure implications?

ISS and Glass Lewis have indicated that they prefer formulaic incentive plans. If a company’s plan features discretionary components, it must be prepared for some negative reactions to that design element.

If an executive’s pay and performance are aligned to quantitative pay-for-performance tests, the proxy advisors may criticize the discretionary plan but are less likely to recommend against the Say-on-Pay vote. On the other hand, companies that fail the pay-for-performance tests are at a much greater risk of getting a “no” Say-on-Pay recommendation.

To overcome these obstacles, companies must clearly outline the rationale for pay decisions. CD&A disclosures are a critical opportunity to tell the company’s story, complete with details around the parameters used to evaluate performance.

Conclusion

Discretion in annual incentive plans allows Compensation Committees flexibility to evaluate performance and determine payouts from a more holistic perspective. It allows room for factoring in unexpected volatility or unprecedented events and aligning payouts with performance even as goals evolve. Each approach to using discretion requires a strong structure to guide decision-making, effective trust and collaboration between executives and Compensation Committees, a commitment to frequent conversations and progress evaluations, and clear disclosure of pay decisions.