CAPflash
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Four Things to Think About When Setting Goals in the Current Political Environment

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Setting goals for long-term incentives has been a persistent problem for companies and Compensation Committees ever since the reliance on long-term performance plans has increased. However, the results of the recent election take the uncertainty to an entirely new level, right around the time when companies are starting to think about setting goals for their upcoming long-term incentive cycle. Examples of challenges various industries will face include:

Energy & Utilities

- Volatility of energy prices given the views on natural gas and oil
- Environmental regulations (i.e. carbon dioxide emissions)
- Traditional sources of energy vs. renewables

Financial Services

- Dodd-Frank implications
- Movement in interest rates
- Return of Glass-Steagall

Industrial and Materials Companies

- Investment in large infrastructure projects
- Renegotiation of trade deals and increased tariffs on goods

None of the above even touches on the implications for businesses if the administration implements a broad-reaching immigration initiative which can have implications on labor costs or if President-elect Donald Trump is successful at dramatically lowering the corporate tax rate.

In many ways, it is similar to the level of uncertainty companies and Boards were dealing with during and immediately following the financial crisis. As Compensation Committees and management plan for 2017 and beyond, a challenge will be setting goals in a company's 1- and 3-year incentive plans. As such, Compensation Advisory Partners ("CAP") outlines four things to think about when setting goals to avoid unintended outcomes and maximize flexibility and accountability.

1. **Scenario Testing** – Run scenarios to test sensitivities and potential outcomes. For example, test what will happen if energy prices go up/down/stay flat and what will happen to payouts under the varying scenarios. Discuss this analysis with the Compensation Committee and establish guiding principles for what is a reasonable payout under the varying scenarios.

2. **Retrospective analysis** – Over periods of uncertainty, companies can meet or miss their goals for many reasons. If the next four years are as volatile as currently expected, Compensation Committees should encourage management to do a retrospective analysis at the end of each performance cycle comparing actual performance to expected performance when goals were set. For example, if the company ultimately delivers $3.00 EPS and the goal was $2.50, did the company get there through true outperformance, because of changes in non-controllable events or because corporate tax

rates declined? This retrospective analysis can help guide the Compensation Committee in determining how challenging the goals wound up being and if appropriate, make necessary adjustments to payouts.

3. **Wider range** – As the ability to predict the future diminishes, it can often be helpful to rethink the range around target that justifies a threshold and maximum payout. For example, if a company has a high level of confidence in the ability to achieve planned performance, then they might set a relatively narrow range around target (e.g., 95% of plan for threshold and 105% of plan for maximum). However, if the company has less confidence in the ability to set its plan, a wider range (e.g., 90% of plan for threshold and 110% of plan for maximum) may be more appropriate such that deviation from plan does not have as much as much of an impact on payouts.

4. **162m Umbrella Plan** – With significant uncertainty it may be challenging to predict what, if any, adjustments a Compensation Committee may want to make to their annual or long-term performance plan. This would be a good time to consider implementing, if you have not already, a 162m umbrella plan to provide the Compensation Committee with flexibility to make adjustments and maintain tax deductibility. An umbrella plan is a structure whereby a bonus is effectively "over-funded" for the Named Executive Officers ("NEOs") such that the Compensation Committee can determine the final payout with some flexibility as long as the final payout is below the umbrella funded amount. For example, in order to qualify as performance-based compensation, a company could establish a maximum to be paid equal to 3% of net income and specify a percentage of the award pool for the each NEO (excluding the CFO). The Compensation Committee then retains negative discretion to pay less than the maximums established. These umbrella plans are very common for annual incentives, but are less common for long-term plans, though this might be a good time to consider whether one might be appropriate.

There are many other ways of addressing uncertainty around goal setting, but these four tips should help maintain a pay for performance structure, hold management accountable and provide Compensation Committees with appropriate flexibility.