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COVID-19: How will companies balance business impacts and reward outcomes?

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1. Overview

The early months of 2020 have seen the spread of the novel coronavirus (COVID-19) and its declaration by the World Health Organisation as a public health emergency. While companies and countries rightfully grapple with the appropriate actions to ensure the safety, health and wellbeing of their people, companies are also assessing the impact on business performance.

The Australian market is down by about 20% from its peak, and some companies have been impacted more than others - eg. Qantas' share price down ~40% since 31 December 2019 as people's travel and movement reduces, while Coles' share price has fluctuated over that time but essentially been flat given people still need staples.

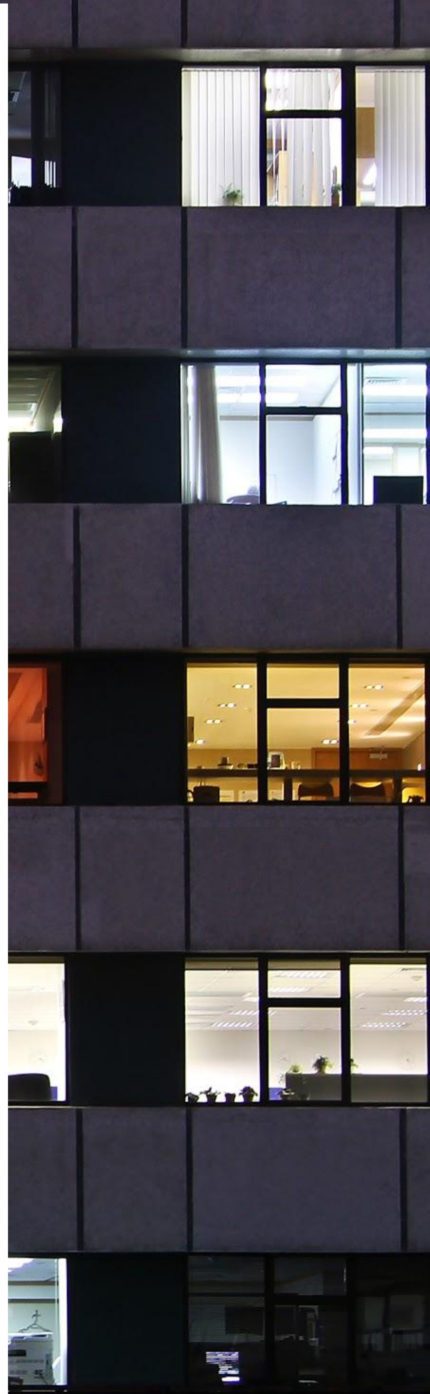
As many companies approach their financial year end, boards may also need to consider what, if any, should be their response on how COVID-19 impacts the pay awarded to senior executives as well as for board fees. For example, if business performance is significantly and adversely impacted by COVID-19, which is outside of the executive team's control, what is a fair and reasonable incentive outcome?

The emerging impacts on business performance of the COVID-19 is likely to intensify both the need for boards to consider employing discretion, and the external scrutiny on companies' use of discretion, in determining reward outcomes. The current scenario will no doubt serve as a catalyst for some companies to either develop and/or stress-test the effectiveness of guidelines they have in place to apply discretion.

Like other unforeseen events, COVID-19 is likely to raise two related, and both challenging, questions:

1. Should discretion be used? and,
2. If so, how?

The questions apply equally to companies that may experience a positive impact on financial results (eg surgical protection supplies), as those that may be experiencing a negative impact on performance (eg tourism / travel / hospitality). There is no clear answer to either question, and the first step in determining whether discretion should be applied will be as challenging as to what discretion to apply if so.



For PwC's perspectives on the key issues we are working through and the longer-term impacts of COVID-19 on business continuity, please see our PwC's global crisis centre's COVID-19 website here.

2. What should boards and remuneration committees be thinking about?

To what extent do we need to balance the interests of shareholders and management for material / critical events outside the control of the company? How do we effectively balance the interests of shareholders, management and employees?

What is the size and materiality of the impact of the unforeseen event, and how clearly can this impact be isolated from other factors impacting performance?

What actions, if any, have or could management take to negate either upstream or downstream impacts of this (eg supply chain continuity risk management, diversification of revenue streams)?

How have other related scenarios (eg unforeseen events) been treated in the past? What precedent would the application / non-application of discretion set for the future?

What is the likely impact / consequence, if any, of not overriding the "formulaic" outcome? Is there a genuinely a higher likelihood that talent will leave, be more difficult to attract, or be harder to motivate? Or are shareholders and investors likely to consider formulaic outcomes unfair?

While in some scenarios, boards may well determine that discretion is not required, the more interesting question is if discretion is applied, how?
Prior experience would demonstrate that shareholders are likely to be critical of any discretion that is seen to be too much in the favour of management. There may also be different considerations when applying discretion to either STI or LTI, where these components exist, or even to the specific performance measure and structure of assessment. By way of example, executives in industries that are negatively impacted by COVID-19 may find themselves receiving differential reward outcomes depending on the TSR peer group - eg if measured against the same industry, may receive an outcome if they have performed better than their peers; but if measured against a multi-industry peer group are likely to be below the median.

3. Example applications following consideration of discretion

No discretion applied	A determination that no discretion needs to be applied may be the right outcome, particularly if the reward outcome aligns to shareholder experience. This is likely to be at least the 'base case' for consideration in seeking to identify the appropriateness of application of discretionary
Retroactively revise targets to take account of the impact of the virus or other events	It's likely to be tough to determine how targets would need to have been set with the benefit of hindsight, given the possible spread of performance outcomes that is generated by COVID-19 - not just across industry, but within company. Additionally, revising targets with the benefit of hindsight is typically not well looked upon by shareholders or external advisors.
Adjust end of year outcomes as above with all impact information available to you	Companies more commonly adjust year end outcomes rather than targets when considering "one-off events". However unlike events where the impact is very clear (eg $Xm spent on restructuring, or $Ym invested in a new IT platform) it's likely to be challenging to quarantine the direct impact of COVID-19 from other factors that may influence broader business performance to be able to determine performance 'but for' the virus. And, with the complicating factor that in any one company there may be both positive and negative impacts on performance.
Consider performance assessment up to a period excluding the virus impact	While the direct impact of the virus might not be able to be isolated from other factors, it's an easier proposition to isolate the time period over which the virus had an impact, a potential solution may also be to consider performance up to or after any period over which the virus had an impact.
Not tie reward outcomes to existing performance metrics at all - fully discretionary payment	While the above examples are anchored in the existing framework, there is the possibility that boards may determine that the impacts are so large or so unpredictable as to render some (but not likely all) existing metrics and targets no longer appropriate to the current year. That is, the board may consider other metrics - how well did management respond to the impacts, how prepared was the organisation before the impact etc. Or, apply a blanket incentive value that balances a view of shareholder experience and management experience. The latter approach may also simplify any complex determinations of cause / effect. Alternately there may be a fully discretionary assessment and a determination not to pay.
Different application by employee segment	While external shareholders will necessarily place greater scrutiny on disclosed KMP pay, the issue is relevant across all employee segments. There may be differential application of discretion, depending on the determination of the board on what basis such decisions are being paid e.g. consideration may be given to reducing executive pay outcomes, but maintaining employee incentive pay spend.
Adjustment to other forms of remuneration	There may be other adjustments that can be made to pay to reflect business impacts, including a reduction in fixed pay for executives for a specific period of time (for example, the approach Qantas has taken through to the end of the FY20 financial year), corresponding reductions in NED fees, and/or fixed pay freezes. In the case of Qantas, the reductions in fixed pay and NED fees were couched as being in the context of broader cost reductions across the organisation.

4. Where to from here?

Unlike many other 'unforeseen events' or events outside of management control, a key variable of COVID-19 is that there is no clear guidance as to how long the impact may last, and significant dependency on market sentiment. Regardless, discussions on the topic are already occurring in boardrooms, and we have observed at least one public response by Qantas (admittedly one of the companies that will be arguably hardest hit) on this issue (see box to the right).

As such, **six suggested immediate steps** for Heads of Reward and Remuneration Committee Chairs include:

- Confirm understanding of business impact
- At a high level, determine potential impact on reward outcomes given year-to-date performance (including on discrete reward elements such as fixed pay spend, STI outcomes, LTI outcomes)
- Identify any differential reward impacts on each employee segment
- Consider other impacts or 'asks' of other employee segments that may impact views on internal equity / fairness e.g. are some employees being encouraged to take annual leave, or even leave without pay?
- Revisit existing guidelines regarding consideration and application of discretion to ensure they are robust, and
- Confirm any messages that have been shared publicly to date regarding principles behind the use of discretion.

And or course, application of discretion is only one of the reward considerations that may arise, with additional questions:

- **Future performance assessment:** How should performance assessment for the following periods be determined? Do existing metrics - particularly in STI - reflect the desired performance going forward? Are targets set on an absolute basis or relative to (unusually high or unusually low) performance in the prior year?
- **Retention and underlying value:** Will there be increased pressure on fixed pay, if there is a perception or reality of lower incentive outcomes or reduced value of equity that vested (eg impacted by uncertain market sentiment)?
- **Mandatory shareholder requirements:** To what extent will any fall in share price for a company require executives to further invest in shares to meet mandatory shareholder requirements?

It cannot be masked that this will be a difficult issue that is likely to generate significant discussion both within and outside of organisations for the FY20 performance year. However, unlike the broader population, boards and remuneration committees cannot wash their hands of the issue, and early consideration of the issues and establishment of clear principles to guide decisions is likely to place organisations in a better position come the end of year.

Case study: Qantas

In their 10 March 2020 release to the ASX, Qantas announced a number of steps to address the impact of COVID-19 on business performance.

Included in a suite of "cost-reduction" measures were initiatives that would impact both executive and NED pay:

- Annual management bonuses set to zero for FY20
- For the remainder of FY20:
    - Qantas Chairman to take no fees
    - Group CEO will take no salary
    - Qantas Board will take a 30% reduction in fees, and
    - Group Executive Management will take a 30% pay cut.

Other global airlines have also made announcements on cutting their executive pay.
While undoubtedly the aviation industry is significantly more greatly impacted than other industries, the prompt action of Qantas is likely to set a precedent in expectation for companies to take decisive action on their pay in recognition of the impact of COVID-19.

How can PwC help?

To have a deeper discussion about these issues, please contact:

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