DECODING DISCRETION:
A FRAMEWORK FOR STRATEGIC DECISION MAKING

HUGESSEN CONSULTING

Authors: Julia Hunt, Shana Srikaruna

As year-end decisions are on the horizon, Compensation Committees may find themselves contemplating discretionary adjustments to their companies' incentive outcomes. Unexpected global events or company-specific issues may warrant such adjustments, as witnessed in 2020 when over half (55%) of TSX60 companies exercised discretion to navigate the pandemic's unprecedented challenges; prevalence stabilized two years later, as evidenced by only 16% of TSX60 companies applying discretion in 2022 . Although use of discretion is generally a less common practice , many directors will likely face the decision of whether to adjust incentive outcomes at some point in their tenure and the decision-making process remains far from prescriptive.

Informed judgement plays a pivotal role in the committee's responsibilities, as these situations require a nuanced and balanced approach that considers all of the relevant facts. There is no one-size-fits-all solution, and this article outlines a high-level framework to support directors considering the use of discretion in their performance evaluation decisions.

1. **Gather Information:** Consider the Context and Implications

Prior to applying judgement, the Committee should have a fully informed view of the performance context and resulting talent implications. Candid conversations at the Board level and an open channel of communication with Management are critical to this process, and conversations on this topic should begin well in advance of the Committee meeting where compensation outcomes are finalized. As part of the information gathering process, we encourage careful consideration of following questions:

Criteria	Key Questions
Business Context	Are the circumstances driven by external or company-specific factors? • If external, does this circumstance affect peers, and if so, what are the expected reactions? • If company-specific, was the event linked to the company's long-term strategy (e.g., significant investment in a new project, acquisition, etc.)? Have the strategic priorities shifted?
Predictability	Was the event foreseeable at the beginning of the performance period?
Materiality	What is the magnitude of the gain or loss in relation to the Company's overall financial performance?
Pay Implications	Which individuals / groups of employees are impacted, and by how much?
Management's Degree of Control	To what degree is this situation within management's control, and to what degree should management be held accountable? Is this attributable in part to actions taken by prior management teams?
Shareholder Lens	What would the shareholder view be in the context of assessing overall (and financial) performance of the company? What is the market/analyst sentiment regarding performance?
Consistency	How has this event been treated in the past (if applicable)?

2. **Establish Guiding Principles:** Focus the Discussion

Aligning on a clear set of guiding principles will enable the Committee to interpret and apply the information gathered through a common lens. Principles will vary by company and circumstance. Examples may include:

- Ensure that outcomes fall within **reasonable line of sight / control to participants**
- **Avoid disincentivizing management** from undertaking activities that will benefit the business in the long-term but may not generate earnings within an incentive award's performance period
- Ensure **a strong pay for performance linkage** is maintained
- Align executive pay outcomes **with shareholder/investor experience**
- Apply adjustments **only where necessary** (may include certain key talent rather than across the board)

3. **Develop Alternatives:** Include Pros and Cons for Each

If there is a view that an adjustment is warranted after considering the criteria laid out above, the Committee will have to consider various approaches by which discretion can be segmented / applied, including based on:

- Employee group (i.e., does the adjustment apply to the full employee group or only those below the executive level, etc.)
- Time period (i.e., does the discretion impact only this year, or future years)
- Magnitude of adjustment
- Component within the program (i.e., adjust a metric, formula, or the final result)
  - Within the metric: an adjustment to a specific input of the financial measure (e.g., excluding an expense)
  - Within the formula: an adjustment to the calculations of results (e.g., changing the metric weighting, adding caps/floors, etc.)
  - Outside the formula: an adjustment to the final result

It will be important for Management and the Committee to consider each alternative's financial and disclosure implications. This will likely include modelling the range of potential outcomes to understand the aggregate financial impact of each alternative, as well as drafting the disclosure before the decision has been finalized. These steps provide a helpful "gut-check" to ensure confidence in the selected alternative.

Conclusion

Boards are tasked with motivating and retaining high-calibre talent while ensuring that pay is aligned with internal and external performance expectations, which can make navigating year-end decisions challenging. A balanced performance evaluation process with appropriate, reasonable, and defensible compensation outcomes is achievable through a thoughtful methodology grounded in robust principles.

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