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MCDOWALL RESEARCH

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Disclosing Executive Compensation Strategy in the S&P/TSX 60

When the requirements for executive compensation disclosure of publicly traded companies changed in the US and Canada securities regulators introduced a new section to management disclosure statements called the Compensation Discussion and Analysis (CD&A.) Listed companies are now required to describe among other things, their executive compensation plans in detail, why they pay the way they do, how their plans pay for performance and how the components of the compensation plans all tie together. In order to report on these requirements cohesively it only makes sense to start by describing the company's executive compensation strategy. The strategy statement should describe the foundation on which executive compensation plans rest but more importantly, it should describe the principles underlying executive compensation as mandated by the Compensation Committee and by extension, the Board of Directors.

Previous disclosure regulations resulted in boiler plate statements. The new regulations prompt listed companies to review their executive compensation strategies, assuming they had ever articulated them, and examine whether they actually link to the realities of their executive compensation programs, now described in much more detail than before.

McDowall Associates conducts a comprehensive annual review of CD&A disclosure practices of S&P/TSX 60 organizations. One area we examine in some detail is the section dealing with Executive Compensation Strategy. Typically presented as a list of strategy statements, the Compensation Committee of the Board outlines what the executive compensation plan seeks to achieve and expresses its values and principles behind executive pay. We have grouped these statements into thematic categories as listed in the table below from the 58 companies where information is available.

Executive Compensation Strategy Theme	*Observations*	*Percentage of the 58 Companies*
Pay for performance culture/corporate performance	45	78%
Alignment with Share/Unit-holder interests	42	72%
Attraction and retention	40	69%
Market competitiveness	26	45%
Link to business strategy	14	24%
Ownership	11	19%
Long-term view to performance	5	9%
Transparency of executive compensation	4	7%
Managing commodity price volatility	4	7%
Compensating executives fairly	3	5%
Team approach to executive compensation	2	3%
Entrepreneurship	2	3%
Keeping executive compensation simple	1	2%

Let us begin by examining the three themes that were reported by at least half the listed companies:

1. 78% mentioned they aspire to pay for performance or reward for corporate results. The notion of pay-for-performance is fundamental in compensation generally and critical to executive compensation plan design. Had it not ranked first would have been grounds for some concern.
2. The second most prevalent statement deals with ensuring that the compensation of executives aligns with how well shareholder investments in the company are performing. This statement ensures that a significant portion of the executive compensation package is comprised of equity based compensation in the form of stock options, restricted or performance share units and deferred share units. Companies appear to be practicing what they preach on this statement. Our research shows that 60% of the average S&P/TSX 60 CEO's compensation package is comprised of equity based remuneration instruments.
3. Attraction and retention of executive talent came in third. Always mindful of ensuring their enterprises are being led by a high calibre of leadership, Boards seek to pay competitively. Note that the next theme, market competitiveness is mentioned by 45% of the S&P/TSX 60 organizations. Paying competitively ties in with attraction and retention by ensuring companies are able to hire and hold on to the executives they judge can do the best job.

These three statements cover time honoured fundamental principles underlying human resources management. Expressed as a single statement and distilled to its simplest form these principles could read as follows: "ABC Corporation employs compensation plans that are linked to company performance and its share price while ensuring that ABC is able to compensate at a level sufficient to attract and retain its executives."

This type of statement is basic and should surprise no one familiar with corporate governance or executive compensation. What is surprising, however, are the important topical themes that are not stated as prevalently in strategy statements yet are fundamental to executive compensation governance at this time:

- **Ownership:** Only 19% of the S&P/TSX 60 mentioned that their executives are expected to own shares of their companies. While the more prevalent statement suggesting executives should align their interests with those of shareholders validates the use of equity based compensation such as stock options and restricted share units, these plans do not constitute ownership per se. It is generally recognized that stock option plan participants effectively rent shares and convert gains into cash at their earliest convenience.
  85% of the S&P/TSX 60 ensures that executives are owners. Not only do they report ownership guidelines but also the minimum number of company shares these executives are expected to hold and how long they are expected to take to acquire them. Yet many of these companies don't mention this very important principle to shareholders in their strategy statements.
- **Link to Corporate Strategy:** While the highest number of issuers reported a link to corporate performance, it is interesting that only 24% chose to report that the company's compensation plans are designed to support the organization's strategic direction, corporate plans and goals. One would hope that the executive compensation plans and especially the metrics used to measure performance are closely coupled with the strategic direction of the company.
- **Long Term View to Performance:** 9% articulated that senior executives are expected to take the long view in managing their enterprises and their performance should be measured with that perspective in mind. The absence of a policy statement dealing with this issue by more than 90% of Canada's elite organizations is noteworthy especially given the sustained interest in deferring compensation and instituting claw back provisions as a result of the recent financial crisis.
- **Other Statements:** Other statements identified are general in nature and industry specific such as those dealing with currency or commodity price fluctuations. On the other hand some statements such as those dealing with teamwork or entrepreneurship are declarations of specific organizational culture. These statements are all useful in giving the reader a sense of the corporate culture the executive compensation plan is expected to support. Our findings show that few organizations provide this insight.

These findings lead us to question whether listed companies review their strategy statements on a regular basis. While those standard statements described most often are fundamental compensation themes, it should be noted that some others such as linkage to corporate strategy and the long term view to performance are topical following the financial crisis. These statements are not made by a number of S&P/TSX 60 companies.

One issue not covered by any strategy statement we reviewed yet dealt with elsewhere in many disclosure statements is the issue of executive compensation and risk. A very hot topic, efforts are being made to ensure that executive compensation is not a risk aggravator through audits and disclosure in this area. A policy statement in this area would show the reader that the Board is addressing this important topic.

Concordance between executive compensation strategy and compensation practices requires better alignment than is currently being practiced. Every compensation committee should schedule a session in its annual calendar to review its executive compensation strategy. After all, most CD&As start with that section and these statements set the tone for the rest of the document that follows.