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Eyes on Governance

Building better boards to deal with compensation issues

INSTITUTE OF CORPORATE DIRECTORS
INSTITUT DES ADMINISTRATEURS DE SOCIÉTÉS

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THE CORPORATE GOVERNANCE and regulatory landscapes have undergone significant change over the past several years. And while greater disclosure has highlighted the huge compensation awarded to many executives, there has been little guidance from regulators or other governance experts on how to better deal with compensation issues, and what role the board of directors' human resources and compensation committee (HRCC) should play.

But after years of living in the shadow of the audit committee, the light is now shining on the HRCC, especially its importance in helping to shape decisions surrounding executive compensation. The committee faces the challenge of coming up with the processes and methodology that should be used to decide how to pay executives, and how to tie that compensation to measurable performance.

"Progressive HR committees go further than assessing the levels of executive pay," says Bonnie Flatt, leader of total rewards at PricewaterhouseCoopers. "Those that are successful take ownership and accountability for understanding how the company's executive compensation programs and policies work."

A recent PricewaterhouseCoopers (PwC)/Institute of Corporate Directors (ICD) study of directors across Canada looked at their perceptions of their evolving roles, responsibilities and expectations, and how they can best carry them out. The study found that boards are struggling to find people who have strong general business experience and skills, coupled with sufficient fluency in HR strategy to contribute to the HRCC.

An HRCC will not be effective without its members having a solid understanding of HR best practices and terminology, and how compensation programs and HR strategies apply back to the business plans and strategies of a company. The HRCC needs to defend its compensation proposals to the entire board —amount, benefits and incremental increases— and the board, in turn, must be able to defend its decisions with rationales that are credible to shareholders.

As well, there are no existing legislated or best-practice requirements for the level of expertise needed by HRCC members. Clearly, financial literacy is required to understand financial results and their implications, but, since the role of the HRCC is to design the compensation system that works best with an individual company's strategy and objectives, experience in executive compensation that goes beyond financial literacy or general business experience is required.

As is the case with financial literacy, an understanding of HR and compensation issues often comes from having dealt with similar matters in the past. It also entails having read and discussed compensation issues sufficiently, to grasp the range of issues that need to be addressed. As a result, there is a growing need for some board members to have had direct involvement in the human resources function in an earlier career.

The right compensation levels are most effectively decided when the company has developed a methodical process to manage its compensation policy. So once there is compensation literacy, the HRCC must work on a plan.

Most recently, the ICD's Blue Ribbon Commission on the Governance of Executive Compensation identified a compensation analysis process (CAP) that an HRCC can use to determine appropriate pay packages. The CAP includes the following six steps:

1. Obtain an in-depth understanding of the business model, strategy and goals of the firm.
2. Develop appropriate executive performance metrics (both quantitative and qualitative) to support the business model, strategy and goals.
3. Determine the appropriate weighting for each performance metric and develop relevant targets.
4. Assess what it takes to motivate an executive with respect to compensation given the mobility of executive talent and other job elements.
5. Evaluate whether or not the total compensation arrangement is in accordance with the performance targets and aligns the executive's incentives with the firm's business model and objectives.
6. Objectively stress-test the entire plan to see if it is fair to the chief executive officer, the firm and investors.

Along with full disclosure of the process used and metrics applied, the ICD Blue Ribbon Commission report recommends that all relevant sources of compensation be provided in a single, easy-to-read table to ensure investors understand the total compensation for senior executives.

There are many resources available to the HRCC to get the knowledge and information it needs. First is internal management, including what is now increasingly known as the chief HR officer as well as the chief financial officer. The CFO should provide not just raw financial results but place them in the context of the firm's strategy, policies and objectives. The chief HR officer should also help the HRCC understand the relationship between executive compensation policy and other HR policies of the company.

Executive compensation consultants and external advisers can also provide comparative information on levels and types of incentive compensation for peer groups to enable continuous benchmarking and performance improvement. They can, at a minimum, verify the financial results that have been tabled but also assist management with scenario planning of the range of compensation outcomes that would flow from varying company performance results. External consultants have developed programs that provide training in compensation theory and practice.

According to Ms. Flatt, by working with external experts on HR issues, board members can ensure that their programs align best to the short- and long-term business plans by thinking through what incentives provide the best motivation and what the cost implications will be under a range of profit scenarios.

Forward-thinking compensation committees are no longer accepting recommendations from consultants and management at face value but asking of them the hard questions when reviewing and approving executive compensation. They are asking for demonstrated links between compensation and company performance, and in so doing, challenging senior management to identify what drives corporate performance and how management can influence it.

Dealing with executive compensation can be a challenge, especially when investors are looking over the board's shoulder. It can be simple in concept but challenging to get it right without a sound base of understanding. Linking rewards with performance targets and strategy, with a balance between long-term vision and short-term performance, isn't always easy. Getting the compensation package right can be particularly difficult in an environment of market and economic volatility. But it needs to be done, and done well.

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The Institute of Corporate Directors (ICD) provides the forum for the Canadian director community to collaborate on and update their knowledge of governance practices in the boardroom. Website: www.icd.ca.

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