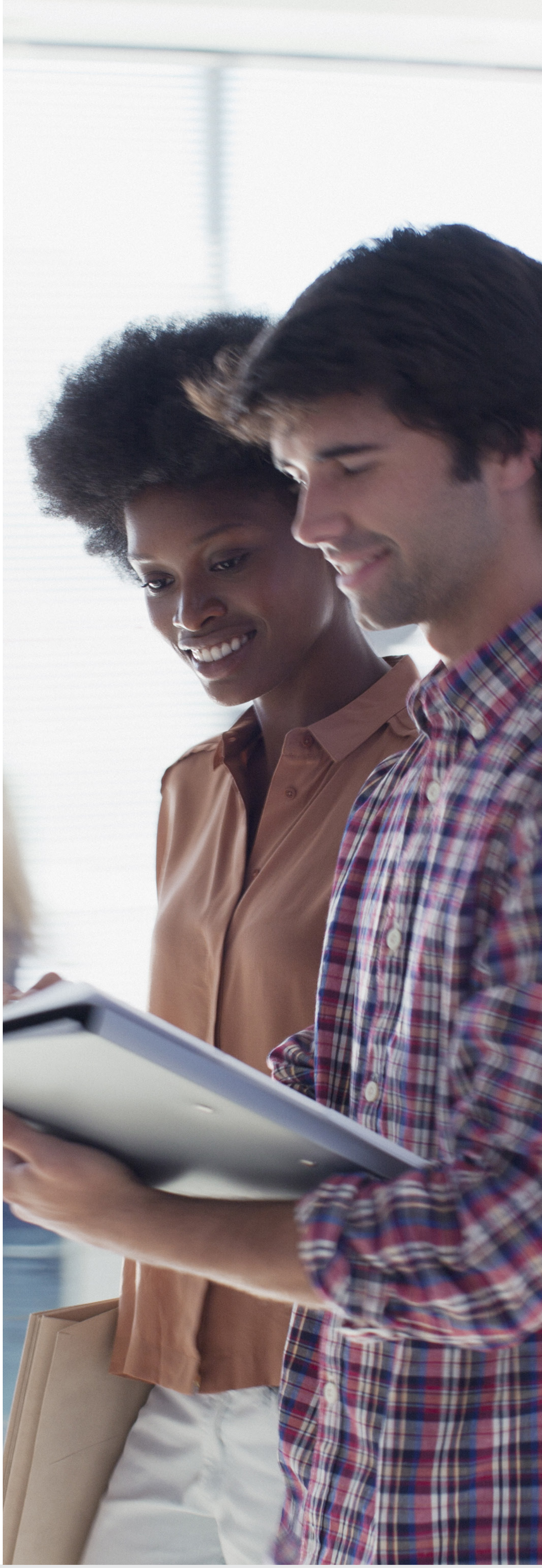
EXECUTIVE COMPENSATION

IT'S TIME TO GEAR UP FOR YEAR-END

We explore executive compensation actions to help you "wrap up" the current year and build a solid foundation for the coming year. Part two will focus on "setting up for success" for next year.



Now's the time to wrap-up compensation-related decisions, but for many executive compensation professionals, management, and boards, the decision of where to focus and how to proceed through the long list of agenda items can be as daunting as prepping for a long Canadian winter.

How do you evaluate the performance and engagement of executives and the organization, on an absolute or relative basis? How about shareholder engagement or the effectiveness of your incentive programs, pay for performance, and benchmarking? With the intense and critical spotlight shining on executive compensation in recent years, organizations must take careful, prudent steps to gauge successes and set-backs from the past year. We've taken a deeper dive into four key focus areas to ensure you are having the right discussions at year-end and making informed decisions that support business needs.

1. PERFORMANCE EVALUATION (INDIVIDUALS AND CORPORATE)

As most organizations utilize a pay-for-performance philosophy for their executive compensation program, compensation committees, boards, and management will be reviewing strategic, operational and financial results to assist them in evaluating performance. The key is to create a strong process that becomes a straightforward business activity, including expectations of periodic reporting and an annual recap. To successfully integrate this approach, consider this:

- Metrics and goals should be set at the beginning of the year. This discussion should include the board's expectations of management when market conditions change.
- Boards should receive regular updates throughout the year on performance and progress against these goals.
- The CEO should provide the board and compensation committee chairs with an annual self-evaluation. In addition, the CEO should provide evaluations of both company performance and individual performance of second-level executives for whom the compensation committee determines remuneration.

WHAT IS UNDER THEIR CONTROL?

The goal of a strong evaluation process is to have no surprises. The reality of business activities is that they rarely follow a predictable path, exposing a data-driven process to an element of judgement. Boards must balance goals and performance outcomes against the executive team's response to changing market conditions. The conditions that are "out of the executive's control" should be considered, including if executives anticipated these events, how they managed them, and ultimately, the assessment of their success in mitigating negative impacts to the company or taking advantage of unforeseen situations.

KEY TAKEAWAYS

- Ensure the board receives the formulaic results of performance against objectives and has a solid understanding of qualitative factors that might have impacted performance.
- Inform the board how the executive team addressed these unanticipated events and capitalized on positive events or minimized the downside to adverse factors.

2. INCENTIVE PLAN PAYOUTS

While qualitative performance discussions are important, at some point, the conversation needs to center on a quantitative result – a number needs to be identified and capture the overall performance of the company and each executive. Depending on the incentive plan structure, this may come via a formula to which the board approves certain inputs and the overall outcome. This holds true for annual cash bonus plans and many performance-based long-term incentive plans (i.e., performance share units (PSUs) or performance stock options).

Agreement and understanding among the executive team and the board is important, however, so are communications with employees, shareholders, and advisory firms. The primary external communication tool about executive compensation outcomes is the annual proxy circular. A careful explanation of any changes to the compensation program, as well as the outcomes approved by the board, should be discussed, including the supporting rationale. Be sure to include additional details if compensation outcomes are not obviously aligned with performance or if the board applied either upward or downward discretion, and if so, why discretion was applied.

MORE THAN COMMUNICATE: ENGAGE

Even the most effective pay decisions may be challenged if shareholders are not adequately informed and engaged. This naturally starts with the proxy circular, including a letter to shareholders. While not a formal requirement, this common practice provides direct communication between the compensation committee chair and shareholders, and the opportunity to explain the rationale for changes and linkages between compensation and performance. Further shareholder engagement may range from briefing executives and directors on compensation issues prior to investor presentations and the annual general meeting to direct engagement with investors to understand their expectations or concerns.

KEY TAKEAWAYS

- Ensure all stakeholders fully understand the results achieved for each compensation plan and the business rationale for any board-approved outcomes.
- Communication messages and avenues are often different based on the audience, whether it's affected employees, shareholders, or external advisors.

3. BENCHMARKING

At year-end, you should also evaluate peer institutions used to benchmark pay-for-performance decisions. Ideally, peer companies are of a similar size and complexity, in the same or related industry, and reflect the competitive landscape for executive talent. Compensation committees typically check the peer group annually to replace companies that are no longer available or an appropriate fit (e.g., resulting from M&A activity or changes in business strategy) and revisit the peer group selection criteria every two to three years to capture important changes in the company's strategy or operations. With the peer group identified, it is important to establish the desired competitive positioning within the group.

The compensation levels of peer companies may be obtained from either publicly available proxy circulars or proprietary compensation surveys. The advantage of public data is pay can be viewed at the company and job level for each peer while compensation surveys aggregate peer data and typically offer more up-to-date information. Many organizations review the market competitiveness of their executive pay programs annually. This is particularly important if the market is volatile, subject to swings resulting from either controllable or uncontrollable events.

KEY TAKEAWAYS

- Revisit peer groups annually and peer group criteria every two to three years to ensure they remain a viable organization for comparison purposes.
- Utilize public sources and compensation surveys to gauge the competitiveness of your compensation arrangements.

4. PAY FOR PERFORMANCE ALIGNMENT

With company and executive team performance determined and outcomes established for short- and long-term incentive plans, the compensation committee can now check the pay-for-performance alignment. This typically includes – but may not be limited to – plotting the company and its peers on a simple two-by-two chart with performance on the horizontal axis and pay on the vertical axis. Ideally, companies performing at about the median of their peer group have pay close to the median. Similarly, if performance is higher or lower than median, pay levels should be similarly higher or lower, respectively, than their peers.

Most organizations use total shareholder return when reporting pay-for-performance results in their proxy circulars. Compensation committees should consider pay-for-performance metrics that are important to their organization, such as those included in their incentive plan designs, rather than focusing too much on what pundits say are best practices.

KEY TAKEAWAYS

- Test the alignment of your executive pay and performance.comparison purposes.
- Consider additional metrics to gain as complete of a picture of your pay-for-performance program as possible.

GOING FORWARD

As we enter fall, some might be tempted to focus only on the activities needed to close off the year and delay planning for next year's executive compensation activities and decision-making. But unfortunately, now's the time to do this planning. Think about how to enhance what worked – and fix what didn't – and plan ahead for next year's expected and unexpected events.

To help you start thinking about the coming year in executive compensation, we leave you with a sample calendar and checklist. Of course, each organization should have its own unique procedures, communication approaches, incentive plans, and committee calendar, but the following can help you gauge if your organization – in general – is on the right track.

1st Quarter

- Executive and company performance results
- Annual bonus and performance LTI calculations
- Executive compensation decisions
- Salary increase budgets, bonus budgets, and LTI grant levels for the broader workforce
- New compensation plan design approval

2nd Quarter

- Performance tracking toward goals
- Annual engagement of external advisor(s)
- HR strategy discussions
- Succession planning

3rd Quarter

- Performance tracking toward goals
- Market trends review
- Introduction of new compensation plan ideas

4th Quarter

- Performance tracking toward goals – preview of year-end results
- Preview of potential bonus/LTI award outcomes
- New compensation plan design details for discussion
- Board/committee self-assessments
- External advisor performance assessment

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