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Executive Compensation Disclosure – questions directors should ask

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The Canadian Securities Administrators (CSA) have proposed to change the rules for how Canadian public companies disclose information about compensation paid to executives. For most companies, the proposed rule changes will dramatically increase the volume and complexity of information provided to the market. They will pose a disclosure challenge, and for some companies will expose problems with the controls and procedures they have in place for executive compensation. This area is likely to become subject to intense scrutiny by both the CSA and investor groups.

The new rules will apply to all Canadian companies, with only limited exemptions for smaller entities. The CSA intends that they be effective on December 31, 2008. Boards and compensation committees of leading companies are planning for them already, and it is recommended that those who are not start preparing immediately. Directors should use the disclosure rules as a basis for understanding the total implications of all their compensation arrangements and for identifying any weaknesses in the associated processes and controls.

Background

In the United States, the Securities and Exchange Commission's (SEC) new executive compensation disclosure rules, which became effective in 2006, significantly enhanced the information provided by US public companies about how they compensate their most highly paid executive officers. The SEC is extensively reviewing these disclosures and working towards still greater transparency, in particular about the triggers for incentive pay. Most recently the SEC added an XBRL-based[1] tool to its website to facilitate easier comparison between the compensation programs of selected companies.

The new disclosures also appear to be supporting a considerable upsurge in compensation-related shareholder activism, including the "say on pay" movement and other shareholder proposals relating to pay for performance.

What Canada can expect

The Canadian Securities Administrators initially issued their own proposed rules for comment in early 2007, and then issued an amended proposal, responding to some of the key concerns raised by commenters, in February 2008. The proposals are closely modeled on the US rules, although with some important differences. The main elements of the proposals are:

- A summary compensation table including a dollar value for the total compensation provided to each named executive officer (NEO),
- A Compensation Discussion and Analysis (CD&A) intended to provide clearer insight into the rationale for an entity's compensation decisions, and
- More comprehensive disclosure about virtually every aspect of an NEO's compensation, including pension entitlements and termination and change of control provisions.

The CSA has proposed an effective date for the new rules of December 31, 2008 (i.e. for proxy disclosures prepared in the spring of 2009).

[1] *eXtensible Business Reporting Language*

Similar to the US, Canada is moving towards much greater transparency about pay for performance, or lack thereof. The Canadian Coalition for Good Governance (CCGG) has emphasized executive compensation as one of its key focus areas, and although the CCGG is not currently supporting the “say on pay” movement, it will certainly use the additional information as a basis for communicating more actively with boards and compensation committees about their compensation practices. The new disclosures will likely be of interest to numerous other institutions, advocacy groups and the media.

Many organizations currently treat executive compensation disclosure largely as a matter of legal compliance. However, it is increasingly clear that executive compensation disclosure is a key aspect of an enterprise’s financial reporting. The design and effectiveness of the controls and procedures that generate this disclosure are fully within the scope of the certificates issued by the Chief Executive Officer and Chief Financial Officer under Multilateral Instrument 52-109.

The company’s existing financial reporting systems should already contain some of the basic numbers to be disclosed (such as salary and bonus). The challenge will be that other information which will be required to be disclosed, such as termination or change of control obligations, is extracted from specific contractual arrangements and may not be part of any "system" as such. Boards should review the disclosure requirements in the proposals as a basis for making an initial assessment of the implications on financial reporting systems and disclosure controls and procedures and identify the required action steps.

Although the CSA proposal does not actually specify who is responsible for writing or approving the CD&A, it will be generally understood as a communication piece from the compensation committee. Writing an effective CD&A will be a considerable task that draws on a cross-section of organizational resources. The initial attempts will be subject to much greater than usual media and regulatory attention. As with Management’s Discussion and Analysis (MD&A), an effective CD&A will not be written in isolation but will reflect the organization’s strategy and goals, so that stakeholders can easily understand how the compensation programs support the enterprise’s short- and longer-term objectives, and why performance awards were issued in the amounts that they were.

Board members and compensation committee members in particular should be thinking actively about executive compensation now and using the time until the new rules are released to identify and resolve any issues with their compensation approach.

To help directors face these challenges, below are sample questions they might ask to better understand the issues and their obligations. The questions are not intended to be a precise checklist but a way to provide insight and stimulate discussion and understanding of this important topic. Directors must use their own experience and judgment.

A. Questions relating to disclosure

Preparing compliant disclosure will be the basic obligation under the new rules. The disclosure will fall within the scope of civil liability for continuous disclosure and will likely be overseen and enforced much more actively by the Canadian Securities Administrators than in the past.

1. Have we analyzed the CSA disclosure proposal to make an initial assessment of the impact? Have we started to craft our CD&A (for example, based on last year's numbers)? Could investors be shocked by any aspect of our initial disclosures under the new rules?

2. How will our compensation disclosure align with our MD&A and other disclosures on corporate strategy? Will our disclosure communicate a persuasive approach to pay for performance that makes sense given the company's strategic objectives?

3. Have we thought through our corporate philosophy toward compensation disclosure and about how the disclosure might create value for our company (or erode it)? Could a more progressive approach to disclosure (both in the area of compensation, and more generally) assist us in communicating our value proposition to the market?

B. Questions relating to risk and control

Preparing compliant disclosure will depend on having appropriate disclosure controls and procedures, and these will be within the scope of the assertions on design and effectiveness made by the CEO and CFO on the interim and annual certificates that they file under Multilateral Instrument 52-109.

An executive compensation strategy always carries risk, which should be meticulously identified and addressed. Consequently, executive compensation programs have a distinct ability to generate embarrassment or even scandal for an organization.

1. What are the main risks relating to our compensation strategies? For example, how do we know they motivate the right behaviour? Do the triggers for performance-related pay make sense? Are we content that we've identified all the tax implications? Is there any scope for disagreement about the interpretation of contractual provisions? Do we need to “step back” and carry out a comprehensive assessment of compensation-related risk?

2. What do we know about the adequacy of controls over executive compensation? Who monitors the contracts and arrangements? Does anyone keep a running tab on our obligations to each executive? What do we need to do differently to comply with the new rules?

3. How well do our disclosure controls and procedures identify and respond to the specific risks of the executive compensation strategy? Are our disclosure controls and procedures reassessed each year with specific reference to changes in our compensation strategies?

C. Questions relating to governance

Most boards understand this area as one of their key responsibilities and accountabilities. The new disclosure rules will shine a light on their performance on compensation-related matters, and open up an array of new challenges for compensation committees in particular.

1. Do we have the right mix of skills on our compensation committee to deal with evolving demands in this area? Do we need a committee member with specific knowledge of executive compensation issues and disclosures?

2. Have we thought about the relationship between the audit and compensation committees? Both have oversight over an important aspect of financial reporting and disclosure. The compensation committee relies on information from the reporting systems overseen by the audit committee. One has oversight over the MD&A, the other over the CD&A. Have we ensured that our governance arrangements adequately acknowledge this overlap and that they function actively to make sure nothing falls between the cracks?

3. Are we satisfied that we are getting the right amount of truly informed, independent advice on compensation matters? Have we considered the philosophy, independence and overall mandate of our compensation consultant and concluded that these make sense in the company's circumstances?

4. Are there proactive steps that we can take to reach out to our stakeholders, so that they intuitively understand and accept our compensation programs and even view those programs as a corporate asset?

D. Questions relating to relating to the compensation arrangements

For many, the ultimate value of executive compensation disclosure is in providing external information that, through investor advocacy and other means, can lead over time to a better market-wide relationship between how executives are paid and the value they create for shareholders.

1. How well do the arrangements reflect our strategic objectives? Are we comfortable that the triggers that will drive compensation higher or lower are consistent with what matters to us as a company in the long term?

2. Are we getting the most out of our compensation consultant? Should we do anything different in the way that we use him or her?

3. Have we stepped back and assessed the aggregate impact of our compensation arrangements? Do we know the entitlements of our senior executives under all termination scenarios and are we comfortable with those numbers?

4. Do we have the right relationship between executive compensation and organization-wide compensation?

5. Do we really understand how our compensation arrangements relate to those of our key peers, competitors, etc.? Are we comfortable that benchmarking and peer group assessments took all the different circumstances into account? Do we understand how those other entities created value for shareholders and how that record compares to us?

6. Have we heard from our shareholders or from other key stakeholders on compensation-related issues, and if so how do their concerns align with our practices?

Conclusion

Attention to the pending disclosure rules is essential if boards want to approach the requirements from a position of strength. Most of the larger Canadian companies have already been thinking through at least some of these issues. Many have used the US rules as a basis for going beyond current Canadian requirements and voluntarily enhancing their compensation disclosures. Most medium-sized and small Canadian companies, however, have not yet done so.

Companies that wait until the final rules have been issued may find themselves struggling merely to produce compliant disclosure. Companies can ease the challenges of complying by approaching the issue proactively. Equally importantly, given enough time, they can use the disclosure challenge as a springboard for a meaningful and valuable internal reassessment of their compensation strategy and practices.

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