

## **Challenges and Changes**

# **Human Resource and Compensation Challenges during the Financial Crisis**

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The financial crisis is having a significant impact on human resources and compensation. Boards of directors face new challenges in retaining and motivating top performers. Decisions on executive pay are subject to unprecedented levels of scrutiny due to new regulations on compensation disclosure and increased interest by shareholder activists.

Directors are operating in a high risk environment, but there are opportunities for HR and compensation committees to not only help the company survive the current crisis but enable future growth. These include:

- improving the alignment between executive pay and performance;
- reviewing executive talent needs and strengthening the leadership team; and
- enhancing disclosure and engaging with shareholders regarding compensation practices.

An excellent resource to help directors, particularly those sitting on HR and compensation committees, is a Director Alert authored by Lisa Slipp of Mercer for the CICA's Risk Management and Governance Board. The Alert, entitled *Human Resource and Compensation Issues Triggered by the Financial Crisis – Questions for Directors to Ask*, is available at [www.rmgb.ca](http://www.rmgb.ca). It outlines some areas that directors should address and provides questions which they can ask to help them effectively oversee the organization's human resource and compensation practices. Much of this article is based on that Alert.

### ***Executive Compensation***

#### ***Approving Executive Pay***

In the current economic climate, there is a heightened interest in executive pay levels. The HR and compensation committee is responsible not only for evaluating executive pay but for approving the company's overarching compensation philosophy.

An effective pay philosophy should clearly articulate the fundamental principles on which compensation is based, but also be flexible enough to allow the company to respond to market and other business changes.

When evaluating total compensation for consistency with the company's pay philosophy, directors should examine pay through multiple lenses, including share of profits, tally sheets of total compensation, wealth accumulation analyses, internal equity, and alignment with performance.

Although not all members of the HR and compensation committee may be experts in compensation, it is recommended that they all comprehend the issues and ramifications of compensation and human resource policy decisions and plan designs.

## *Evaluating the Link between Pay and Performance*

Establishing and articulating a clear link between pay and performance is critical, particularly during economic downturns. While investors expect a company to pay for performance that contributes to the company's long-term success, concerns have arisen about incentives that motivate undue risk-taking and compensation plans that appear to pay for failure.

When used properly and effectively to drive company performance, incentive compensation benefits both employees and shareholders. When this relationship is out of line, however, undue risks may arise. It is critical that directors receive adequate information on the company's highest paid employees and understand the drivers and related risks in their compensation program.

Compensation committees must assess the links between performance measures forming the basis for the incentive compensation plan, company strategies and compensation outcomes. Directors should consider:

- whether pay is awarded when the executive or company failed to meet goals (for example, when a company misses its internal targets yet exceeds earnings goals as a result of market forces beyond management's control);
- weighting on short-term versus long-term goals;
- alignment and balance between executives' interests and the company's interests;
- whether both qualitative and quantitative goals (and not just stock price) are considered; and
- whether final decisions are made independent of management.

Plans that allow for discretion provide flexibility to make adjustments for unexpected events, which assists the company in retaining its best talent during bad times. Discretionary adjustments should not be based on arbitrary decisions but determined through the application of informed judgment that can be explained in the proxy disclosure.

Directors should also review the compensation program to check that inappropriate risk-taking is not inadvertently encouraged. Red flags include:

- over-emphasis on quarterly or annual results;
- over-reliance on highly leveraged equity vehicles;
- one-dimensional performance measurement;
- failure to "stress test" plans for outcomes under extreme scenarios, both positive and negative; and
- poor ties between the compensation time horizon and the time horizon for sustainable results.

## *Overseeing Equity Compensation Programs*

Equity awards are a significant component of executive compensation. The board is responsible for overseeing the company's equity grant practices and making decisions about equity awards.

In light of current market volatility, compensation committees may need to review the effectiveness of outstanding equity awards and the number of shares available in their equity pay plans. Changes to the eligibility, vehicles and mix of equity plans may be necessary to manage cost and dilution as well as employer and employee perceptions of value.

The majority of mid- to large-sized companies calibrate their equity awards using a dollar value rather than fixed share guidelines; consequently, in a down market the number of shares needed to deliver the same theoretical value may increase significantly. Shareholders may object to

increased dilution and vote against requests to increase the available equity under incentive plans.

Directors should review the applicability of standard valuation approaches in setting equity grant levels. They may also consider replacing or supplementing an existing equity-based plan with a cash-based long-term incentive.

The issue of “underwater” stock options is presenting a challenge for many companies. Boards may consider at what point an option exchange program would be advisable. This will depend on the degree to which options are underwater, the duration for which options have been underwater, and their potential for recovery. Directors should also consider impacts on participating employees and shareholders.

### ***Talent Management***

For a company to succeed, top performers must be identified, developed and retained, while underachievers must be managed. Because of the importance of talent management to the company as a whole, it increasingly appears on board and committee agendas.

Retaining key executives during tough economic times should be a top priority, and can be difficult when equity retention hooks have been diminished through declining share value. The board may consider conducting an executive talent assessment to ensure that key contributors are identified and rewarded. Committee members should consider if rewards based on individual performance and potential are sufficiently differentiated, and whether career opportunities and other non-monetary rewards could be used for strong performers.

If the company is downsizing, it is important to retain sufficient core capabilities to prepare the company for success in the future. Directors should evaluate the company’s overall talent needs and how they are expected to change over time.

Finally, it may be appropriate to replace individuals whose skill sets are no longer closely aligned with the company’s strategies. For some companies, the current economic situation may present an opportunity to recruit top-notch talent to fill gaps in the leadership team.

### ***Disclosure and Shareholder Engagement***

#### ***Crafting Effective Compensation Disclosure***

The disclosure of executive compensation is an opportunity to tell the company’s compensation story and demonstrate strong pay governance practices. It should provide insight into executive compensation as a key aspect of governance and help investors understand how decisions about executive compensation were made. It is currently a key focus of both regulators and investors.

In the current economic climate, it is critical that compensation disclosure clearly articulate the company’s pay philosophy, the link between pay and performance, and the rationale for the board’s compensation decisions. Directors should be wary of “hot button” issues that may detract from pay for performance, such as severance and change-of-control benefits, perquisites, and supplemental retirement plans.

#### ***Say on Pay and Shareholder Engagement***

If shareholders do not consider the executive pay program to be reasonable, defensible and properly linked to company performance, they may demand that the company rein in what they

view as excessive pay. To avoid this, directors should recommend that corporate governance procedures address accountability to shareholders, ensure that the company's pay-for-performance philosophy aligns management and shareholder interests, and help develop compensation disclosure that is detailed and transparent.

"Say-on-pay" policies are catching on among some of Canada's largest companies. Although these votes are advisory in nature and are not binding on the company, if a majority of investors vote against the executive compensation program the company may feel obliged to change its pay program in response to shareholder concerns and to address any potential lack of confidence in the board that poor vote results may signal.

Directors should consider the best way to solicit feedback from investors on the compensation program. Adopting a "say-on-pay" policy is one option. Others may include shareholder discussions or written communications with management and the board or committee, or an opportunity to ask questions at the annual meeting.

By taking advantage of this period of heightened scrutiny to review and improve human resources and compensation practices, directors can help their companies weather the current economic crisis and set them up for future growth.

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*The RMGB publications **20 Questions Directors Should Ask about the Role of the Human Resources and Compensation Committee** by Lisa Slipp and Paul Hooper of Mercer and **Human Resource and Compensation Issues Triggered by the Financial Crisis: Questions Directors Should Ask** by Lisa Slipp are available at [www.rmgb.ca](http://www.rmgb.ca).*

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