

Executive Compensation

David Bell • *Ceridian Canada Ltd.*

A well-designed executive compensation plan focuses on a number of important objectives. It attracts and retains the talent necessary to lead complex organizations to success. It aligns the interests of executives with those of shareholders. It focuses the efforts of executives on achieving the organization's business goals, both short- and long-term. Finally, it provides programs that are regarded as credible and responsible by investors and other stakeholders, and that meet legal and regulatory requirements.

While these objectives have not changed, the manner in which companies are achieving these objectives is evolving rapidly. This is unfolding in a context of growing demands for transparency and accountability.

An organization developing an executive compensation program will improve its chances of success by following five approaches. First, define the organization's short- and long-term strategies, objectives and key measurements. Second, vest responsibility for executive compensation in a compensation committee consisting of independent board members. Third, take a total rewards perspective by looking at each component of the compensation program as part of a portfolio of provisions rather than stand-alone items. Fourth, establish the executive compensation portfolio to provide an appropriate allocation of base and variable (at risk) compensation, short- and long-term programs and performance incentives versus retention and attraction incentives. The optimal mix will vary by company. Fifth, make the program as simple as possible.

PERFORMANCE OBJECTIVES AND MEASUREMENTS

All executive compensation programs and decisions should derive from the performance objectives and measurements of the participating executives.

Traditionally, executives' performance measurements have been focused on hard financial metrics such as earnings-per-share, total shareholder returns, revenue and profit before tax.

In recent years, there has been an increasing concern that an excessive focus on financial results will actually cause a decline, over time, in financial performance. The argument is that financial results are the result of doing everything else well. Executives should also be measured on that.

Executive performance has normally been measured against the organization's pre-established targets. An emerging practice is to measure company performance, and reward executives based on the organization's performance relative to that of a designated group of similar companies (usually in the same industry). Since publicly available performance data from other companies is almost all financial in nature, so are comparative performance metrics.

THE EXECUTIVE COMPENSATION PORTFOLIO

In crafting the executive compensation program, companies need to determine where they want to position their compensation relative to the market. Most want to be at the market median, while a substantial minority seeks to be above market.

One major challenge in establishing market-competitive com-

pensation provisions for executives is identifying an appropriate group for benchmarking. That benchmark can consist of direct competitors, companies with comparable revenue or employee populations, companies in the same region and companies that the organization would like to emulate.

The executive compensation portfolio can be made up of six elements.

1. Base pay. This comprises a decreasing portion of executives' total compensation. That is a natural corollary of the increasing importance of incentive-based rewards. In recent years, base pay annual increases for executives have averaged only a few tenths of a percentage point more than increases for the broader employee population.

For chief executive officers (CEOs) of companies in the S&P/TSX Composite Index, base pay averaged about one-third of total compensation. It averaged about one-fifth for the 60 largest companies on the index.

The mechanics of executive base pay programs are much the same as for other employees. Executives earn increases based on individual performance, internal equity and competitive market rates for comparable positions.

The percentage of total compensation made up by base pay is inversely proportional to the executive's ranking in the organization.

2. Non-discretionary cash bonuses. These are a significant element of executive compensation. They are the largest incentive compensation component in organizations that are privately held, and where stock-based incentive programs are not applicable.

Non-discretionary bonuses are tied to the achievement of measurable targets. There is usually a threshold level of performance required before any payout is made, a target level of performance at which the target payout is made and a higher level of performance at which the maximum allowable payout is made.

These bonuses are usually based on performance within a fiscal year. The shorter time frame for measuring and rewarding performance is consistent with short-term (quarterly and annual) shareholder expectations.

3. Discretionary cash bonuses. These bonuses are not linked to specific performance measurements or targets.

Discretionary bonuses may be appropriate where company performance is weak, thresholds for non-discretionary cash bonuses have not been met and where there is a need to provide additional compensation to key executives for retention purposes. In some cases they are used for valued achievements that are not rewarded through other components of the compensation package.

Despite these opportunities, they are decreasing in use.

4. Stock options. Stock options, or other share-based instruments, are intended to align the interests of executives with those of shareholders by encouraging executives to increase share prices.

A stock option program provides an executive with the option to buy shares — typically at the fair market value (FMV) of the stock as of the day the option grant is issued. Some companies have begun to price options above the FMV so that the options will not have any value unless the stock price attains a stipulated increase in value.

The options usually vest over a period of three to five years. The option recipient usually has five to 10 years from the option grant date to exercise the options. One emerging trend has companies making the vesting of options dependent on the achievement of specified performance objectives, rather than simply on the passage of time.

Stock options do not completely align the interests of executives and shareholders. Unlike direct share ownership, stock options do not entail the possibility of financial loss, and do not reflect returns to shareholders via dividends. Accordingly, an increasing number of companies are requiring executives and board members to have a defined amount of personal share holdings.

One of the criticisms of stock options is that, in a bull market, even poorly managed companies experience an increase in share price. That rewards executives even when their organization's performance is below average. Companies can mitigate this risk by pricing options above the FMV as of the date of the grant, or by providing shorter time frames (perhaps five years rather than 10) for the exercise of options.

Conversely, well-run companies may experience a decrease in share price during a bear market. That can have a significantly negative impact on executive morale and retention. In such cases, some companies have chosen to revalue their options (reduce the price at which they can be converted into shares).

This can be perceived as sheltering executives from the pain felt by shareowners, which violates the principle of aligning the interests of executives and shareholders. Option revaluation is becoming rare.

A less controversial approach to this problem is to reduce the stock option component of the executive compensation package, and to increase the bonus component (especially non-discretionary bonuses based on the individual's performance rather than the share price).

Option income is currently taxed as a capital gain. Individuals are not taxed until the options are actually exercised. In this way, option income is more tax-effective than regular income.

Until 2004, options had not been expensed by companies. They acted as an expense-free form of compensation. Now that they must be expensed, many companies are expecting to grant fewer options to fewer staff.

5. Stock appreciation rights. These are like stock options, except that the recipient does not actually have to buy and then sell the shares vested. Stock appreciation rights involve notional stock.

They have the advantage of providing cash compensation if the share price increases, but not diluting shareholder equity. They are often used by multinational corporations for executives in countries where stock option programs are not allowed by law.

6. Share unit plans. Under stock option and stock appreciation rights plans, executives are compensated only on the increase in the value of the shares over the option price.

Under share unit plans, executives receive the full cash value of each share unit granted rather than just the appreciation of the share price. Depending on the plan, the share unit holder may receive cash or actual stock at the point of exercise. Share unit holders will also normally receive the same dividends as regular shareholders.

Because each share unit has more value than a stock option, fewer units need to be granted to provide the same compensation value to the executive.

Share unit plans can be criticized for rewarding executives even though the stock price may have declined. Also, because of the smaller number of units typically granted, there is less upside (compared to stock options) for increases in share price.

However, they encourage executives to protect or increase the existing value of shares, and to preserve or enhance dividend yields.

Income gained under share unit plans is currently taxed, upon receipt, as ordinary income. There are three types of share unit plans:

Restricted share units. These units vest under a predetermined schedule, typically at the end of a specified period such as three years.

Performance share units. These are increasing rapidly in popularity as an alternative or complement to traditional stock options. Performance share units vest depending upon the achievement of certain predefined and time-bound performance objectives.

Deferred share units. With these units payment is deferred until the executive's employment with the company ends. They direct executives' attention to the long-term performance of the organization. An unintended consequence of deferred share units may be to encourage executives to leave if they anticipate a significant reduction in share price.

EXECUTIVE BENEFITS AND PERQUISITES

Company practices on benefits and perquisites differ widely. The general trend is towards a reduction in special provisions for executives.

For benefits, the most common practice is for companies to provide the standard insurance programs to their executives. Where the amount of a benefit provision is contingent on income (life or disability coverage, for example), some companies will adjust the standard maximums for coverage to reflect the higher levels of income that will need to be replaced in the event of the death or disability of an executive.

Similarly, for companies with defined benefit pension programs,

applying the standard income tax maximums for registered pension plans will result in executives exceeding the maximum benefit levels. Some companies will bridge this gap through supplemental executive retirement plans. These plans cannot be financed from a pension fund. Payouts are treated as regular business expenses.

A large portion of executive compensation is based on incentive rewards rather than salary. As a result, companies have to decide whether income-contingent benefits such as pensions should be calculated on the executive's salary only, or on salary and bonuses.

Perks should be congruent with the company's desired culture. A hierarchical organization will tend to have more. A flatter, more egalitarian organization, or one with an active board or shareholders, will tend to minimize perks.

Justifiable perks are usually related to the nature of the demands of the executive's job. For example, memberships in golf clubs, social clubs or business associations are sometimes provided for the purpose of customer meetings and networking.

PSYCHOLOGICAL COMPENSATION

While compensation discussions tend to focus on financial provisions, a total rewards approach also looks at non-financial or psychological compensation. This is directed at more intrinsic motivators.

An executive's psychological compensation is most likely to come from the characteristics of his or her work environment or individual nature. Examples include congruence between work and values, degree of autonomy, relationships with peers and more senior executives or board members, relationships with the people they lead, the opportunity for visible achievement and public recognition, intellectual and professional challenge and the ability to have an impact outside the company by being involved in charitable, educational, public policy or other community endeavours.

In summary, executive compensation has become a subject of considerable public scrutiny. The result has been a marked improvement in transparency and accountability, compensation program design and governance. Boards and compensation consultants are becoming more creative in developing incentive programs tailored to

reward specific individual performance and behaviours.

The prerequisite for an effective executive compensation program is a clear understanding and definition of the organization's business objectives, performance drivers and performance measurements. Once these have been established, the design of a total rewards package becomes an exercise in crafting an appropriate mix of the various executive compensation components to drive the behaviours required to achieve the organization's short- and long-term objectives.

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