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# Pushing for Change: Globalizing Executive Compensation Governance



**Brent Longnecker**  
Longnecker & Associates



**Christopher S. Crawford**  
Longnecker & Associates

**A**s the world becomes smaller and enterprise fluidly crosses international borders, business leaders across the globe are being challenged to meet the special compensation needs of their growing and diverse workforce — particularly at the executive level. With the help of the international print and broadcast media of late, compensation issues have “gone global.” International audiences continue to witness the scandalous side of executive compensation as the media unveils examples of executive “excess” within some of the world’s largest corporations, such as Enron and WorldCom. The resulting regulatory consequences also have had a global impact. Sarbanes-Oxley, along with New York Stock Exchange (NYSE) and NASDAQ guidelines, has been enacted to restore accountability to the business world on a global scale. From competitive compensation packages to foreign regulations, these workforce trends present business leaders with new questions and concerns as they work toward a worldwide pay-for-performance compensation system. This article looks at the executive compensation governance practices in the United States and compares and contrasts them to Canada, the United Kingdom and other countries around the globe in order to find “a middle ground” in terms of regulations and practices that will be most beneficial on a global scale.

## The Current U.S. Executive Compensation Environment

Before the onslaught of scandals in the United States, many of America's corporate giants were on an upward spiral, with top executives reaping the benefits of their continued successes. For many, these benefits came in the form of handsome bonus packages, a wealth of company stock options and countless other company perks. From private jets to extravagant company parties, executives in the top seats enjoyed all of the spoils of their various positions of power, while at the same time enjoying the respect of their employees and the public at large.

However, the ensuing string of corporate scandals at Enron, WorldCom, Tyco and Adelphia, among others, did much to expose weak links in the total executive compensation system in the United States, leaving an angry public, distrustful shareholders and a shaky economy in its wake. Tarnishing some big-name executives in the United States has had the unfortunate consequence of tarnishing the reputation of executives as a whole on a global scale.

These very public cases of executive wrongdoing have turned both the public's attention and the attention of federal regulators toward the problems with executive compensation in the United States. In response to the overwhelming demand for government oversight, Congress, the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) have doubled their efforts at curbing excessive executive compensation and enforcing board of director and consultant autonomy.

The regulatory aftermath includes consequences felt far beyond the U.S. borders. The massive amount of time and money executives spend fact checking and analyzing their company's financial records in this post-scandal environment continues to wound the corporate world in the profit realm. While Sarbanes-Oxley might have succeeded in its goal of creating

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greater corporate oversight by directors, it also has left executives and other members of the board with little time to truly understand and implement proper compensation practices within their companies. As a result, the job of regulating executive pay is still in the wrong hands — those of the very executives whose names appear on the checks of board members who lack an independent perspective on the ideal processes (Internal Pay Equity 2005.)

### Executive Compensation in Canada

While the United States still struggles with its own version of balancing regulations with reasonable business monetary and time requirements, outside the country, Canada is one of the most aggressive countries in regulating compensation (Martinneau 2004). This country is making strides in enforcing good business practices and limiting executive compensation excess.

## *In Canada, the executive compensation landscape is changing*

In Canada, the executive compensation landscape is changing as governing bodies and shareholders are beginning to demand additional analysis and reporting of salary packages. Similar to the United States' SEC regulations, the Canadian Securities Administrators (CSA) requires public companies to report compensation packages for C-level executives. But unlike the United States, Canadian companies are not required to have an independent compensation committee in place to offer objective insight on various compensation issues to directors.

For example, the CSA has developed Proposed Policy 58-201 that explains its view of "effective corporate governance" and Proposed Policy MI 58-101 on the disclosure of corporate governance practices. The proposals for 58-201 encourage a compensation committee of independent directors, a written explanation of all related operations and the privilege of an independent counselor. The proposals for 58-101 address public disclosure of the role of individuals involved in the company's compensation committee.

In addition, the Ontario Securities Commission (OSC) has proposed further details related to these

policies that would be enforced throughout Canada, except Quebec and British Columbia (Martineau 2004.)

Furthermore, greater responsibility is being given to Canadian boards of directors, and the country's legal system is testament to this progress. In 2002, the Ontario Court of Appeals in *UPM — Kymmene Corp v. UPM — Kymmene Miramichi Inc.* ruled that the board of directors was uninformed and unprepared to make a decision in favor of the disproportionate compensation package for the new board chairman. The trial unveiled that all board members were not present at decision time, that appropriate counsel was not sought, and that the directors failed to conduct due diligence on the history and details of the employee contract before making a decision.

The court's ruling sent a clear message of accountability for boards of directors by negating the protection of the "business judgment rule," the defense for most directors when no due diligence was present. The ruling concluded, "The principle of deference presupposes that directors are scrupulous in their deliberations and demonstrate diligence in arriving at decisions." (Campbell, Gans, Viirland 2005.) Basically, the court said that the board did not take appropriate action to make a responsible decision on the board chairman's compensation. In addition, the ruling demonstrated that the "business of judgment" protection that board members had previously enjoyed would not overshadow the significance of their decision-making responsibility. Although the board of directors did not receive a sentence in this scenario, the legal system's ruling confirmed Canada's commitment to a more regulated compensation review process.

### **Europe and Asia**

One major difference in compensation in the United States and compensation abroad — at least in most democratically ruled, capital-driven countries — is the lack of an SEC, Congress or Internal Revenue

Service (IRS) to scrutinize compensation procedures. While most stable, democratic, well-established countries have three governing entities, including a government, taxing authority and shareholder activist groups, many do not exercise the same degree of power as U.S. groups. For some regions, the only institution involved in compensation regulation is the individual country's national bank, which may require information to be reported only when an employee is awarded a stock option package from a U.S. company.

However, with growing awareness of potential compensation "land mines," many other countries are beginning to create their own governing bodies to regulate compensation practices within their borders. Europe, for example, has been a driving force behind the growing initiative to improve corporate governance abroad. Because of the many corporate scandals that have taken place — Elan, Vivendi, ABB, Skandia, Ahold, Parmalat and last year, Royal Dutch/Shell — several countries in Europe have already put their own governing practices in place. Although Sarbanes-Oxley has yet to extend its regulations beyond U.S. borders, many European countries are choosing to comply, in hopes that this adherence to U.S. standards will increase their access to capital markets abroad. Others are simply

trying to stay out of court. European directors and board members are, in many cases, being held responsible for the actions of their stateside counterparts, and being called into the courtroom for class-action lawsuits and SEC investigations of U.S. companies.

Led by Great Britain's National Association of Pension Funds, the Association of British Insurers and several U.S. and European fund management companies are working to ensure increased accountability and communication in the boardroom. These organizations and individuals are encouraging management to provide details on everything from executive compensation to the selection process of the board and auditors as well as their pay structure. Last year, the London office of Institutional Shareholder Services (ISS) began tracking nearly 900 European companies in 16 countries, assigning each a "corporate governance quotient" so investors could track their progress. Additionally, of the 30 largest European asset managers, 20 factor governance into their investments.

In Italy, the fraud case at dairy-giant Parmalat has inspired new levels of governance progress. In fact, the Italian Stock Exchange is providing incentive for good governance practices by forcing companies to provide explanations of why they refuse to comply

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with the country's corporate governance code. The Italian government also is in the process of drafting a new law on financial regulation that will give federal regulators greater power to investigate, enact stricter accounting practices and force companies to offer disclosure.

While the actions in many countries indicate a change for the better, Europe still has far to go before words like "open" and "transparent" are used to describe the inner dealings of the boardroom. Some of this can be attributed to the fact that many companies in Europe, including Spain and Switzerland, are still too secretive in voting rights, and shareholders still swing largely in favor of the founding families.

A similar situation exists in many parts of Asia, where many companies are still owned by a single shareholder group, usually a family. In fact, an estimated 60 percent of Asian companies are family-owned, leaving much to be desired in the financial disclosure department (Balfour, Tashiro 2004). Many companies still have yet to create independent audit or compensation

committees, and although some have corporate governance programs in place, enforcement of such programs is lax at best. For example, in Asia, corporate governance programs are still a long way off from the rest of the world, in terms of regulations:

- ▶ Owners of the country's many family-owned businesses make deals with private affiliates in their own favor
- ▶ Corporate finances are still indiscernible
- ▶ In many cases, boards of directors are far from independent, with many having ties to company executives.

According to the ISS's corporate governance quotient, however, some Asian companies are making real progress in infusing independence in their processes. In Singapore, for example, the companies with the highest quotient are government-owned, while Japan's highest marks belong to those companies with large foreign ownership.

### **The Effects of U.S. Regulation**

As U.S. regulations on executive compensation have become stricter and more widely applied, foreign countries are feeling the repercussions as well. Specifically, U.S. policies have influenced most countries in one of two ways. One way is as a result of the increased scrutiny of executive compensation-related issues, some foreign-based companies have been dissuaded to do business in America and have delisted their American Depository Receipts (ADRs) from the NYSE. Many of these companies are unwilling to dedicate the funds' time and effort into complying with U.S. standards, especially smaller companies that would rather become private. The additional regulations have forced international companies to think twice about beginning or continuing to publicly trade stock in the United States.

However, companies that are headquartered in more progressive countries view U.S. regulations as an ethical

business model and encourage their government to implement a similar system. While they recognize the additional costs involved, these companies are willing to make the additional investment to ensure compliance and continue business operations in the United States. Also, in these countries, many politicians are using executive compensation regulations as a way to leverage their own campaign platforms by appealing to the masses with ethical standards. But at the same time, they want to implement reasonable business practices that encourage corporate growth.

### Finding the Middle Ground

In an ideal situation, a global compensation system would reflect not only the employees' performance, but also the economies of scale of the specific country where they are working. Although some multinational businesses are starting to take this to heart, various challenges continue to keep a worldwide compensation strategy in the distant future for many companies.

The main challenge in developing this system is the lack of a streamlined comparison formula. There is an inherent disconnect in comparing countries on executive compensation regulations, as the relating factors are more complicated than the pay structure itself. Subjective factors, such as cultural beliefs, reward mentality and job performance, and objective factors such as tax laws and accounting treatment, make this comparison virtually impossible across all borders.

To compensate for these variances, some multinational companies tend to treat bonuses or long-term incentives (LTIs) on a common global basis, but set basic pay locally. Stumbling blocks range from benefits to tax differences. In the United States and abroad, companies face the same executive compensation challenges of attracting, retaining and motivating top corporate performers. While foreign countries continue to develop a more regulated compensation system, the United States'

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pay-for-performance orientation is an important lesson for countries to adopt, especially for South America, Central America and Eastern Europe, where the system favors base pay, benefits and perks instead of the pay-at-risk structure.

But how do countries introduce and move to a worldwide pay-for-performance system? One solution includes minimizing fixed costs, including base pay, benefits and perks, in the world economy, where resources — pay and people — are finite. Organizations such as WorldatWork are helping to facilitate the pay-for-performance philosophy on a global scale. WorldatWork has established teaching facilities throughout the world to strengthen each country's business infrastructure. Subject matter ranges from the basics, such as presenting general HR issues in China, to more advanced level material on executive compensation in Europe.

By sharing compensation strategies globally, companies both here and abroad can learn and adopt best practices. While the United States is perceived to be the global authority on pay-at-risk structure, it is necessary for all countries, including the United States,

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to look worldwide for HR ideals. For example, U.S. executives could benefit from knowledge regarding the treatment of assembly line workers in China. In addition, U.S.-based companies should consider the European standard of longer vacations as a way to release stress and increase productivity. A greater acceptance and adoption of best practices worldwide would help achieve a global pay-for-performance system.

### **Suggestions for Compensation Practitioners**

Global pay strategies are likely to focus on four areas henceforth:

- ▶ The positioning of pay relative to the market
- ▶ Short-term incentive design
- ▶ LTI design
- ▶ Consistent methodologies for job grading and leveling.

Seemingly less prevalent in the mix so far are work-life programs, perquisites, training and development, recognition programs and career programs.

To implement global compensation solutions, compensation professionals must incorporate input from all geographic regions — distilling the variations of wage types, currency conversions, compensation program elements, business rules and legislative

requirements of each region. For example, the United States may plan employee salary increases in monthly terms while companies in Asia calculate them on an annual or seasonal basis. Once the panoramic view from all stakeholders is considered, gaining agreement on standardized practices will be much easier.

Additionally, if practitioners can help facilitate a direct reporting relationship between the local HR function and the corporate HR function, they will be helping to facilitate the monitoring aspect of any pay strategies that are implemented.

### **Future Implications**


The actions of U.S. companies are, in many cases, a barometer for business practices for the rest of the world. With new U.S. regulations providing the incentive, honest reporting is on the rise. The United States is making strides in setting standards of good governance practices that are gaining favor and adoption abroad. Although many argue these regulations are too rigid, the standard eventually will move toward the middle, and companies across the globe may then follow suit.

The Center for Advanced Human Resource Studies believes managers of multinational enterprises will work through their web of local cultures and systems and settle into one of three strategies:

- ▶ Creating compensation systems consistent with most or all of the local environments in which they compete — by providing tailored systems in each market
- ▶ Applying the corporate headquarters compensation system as a template for each country, tailored when necessary for tax and labor regulations
- ▶ Gathering the best ideas from around the world and combining them into an integrated set of practices that can be used consistently across subsidiaries and local host countries.

In today's global environment, it is necessary to take a variety of cultures and benchmarks into consideration when reviewing corporate governance

and pay systems, which requires collaboration throughout the world.

Tackling the challenges will result in a positive change. A global approach to pay strategy will enable companies to better manage labor costs, create internal equity, ensure effective governance and facilitate global expansion efforts. Such an approach also will improve global employee mobility, promote greater consistency in pay management on a global scale and encourage increased efficiencies in money spent on compensation planning. 

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## Authors

Brent Longnecker, CCP, CBP, CMC, is an executive compensation expert with more than 20 years of experience. He is president of Longnecker & Associates, an executive compensation and corporate governance specialist firm based in Houston. With professional designations of CCP, CBP and CMC, Longnecker was named one of the Top 25 Most Influential Consultants for 2005 by *Consulting Magazine*. He can be reached at [longneckerb@toddorg.com](mailto:longneckerb@toddorg.com).

Christopher S. Crawford, managing director with Longnecker & Associates, has more than a decade of experience in HR management and consulting. He is a national speaker and co-authors articles and books on this area of specialty. He can be reached at [crawfordc@toddorg.com](mailto:crawfordc@toddorg.com).

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