

## Special Comment

# Moody's Corporate Governance

July 2008

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## Expanded Disclosure On U.S. Executive Compensation Offers New Clues For Creditors

### Overview

Executive pay is incorporated into Moody's credit analysis of rated issuers because compensation can be a determinant of management behavior that affects indirectly credit quality. In 2007, U.S. public filers had to comply for the first time with substantially altered and expanded Securities and Exchange Commission (SEC) rules on required disclosure of executive compensation. In April 2007, Moody's published a detailed "user's guide" to these new rules.<sup>1</sup>

Based on a review of 350 of the proxy statements filed in 2007, the SEC has made clear that it expects improved compliance in 2008 with the new rules in several key areas.<sup>2</sup> The SEC found deficiencies in some areas that are particularly useful to credit analysis: 1) disclosure of performance metrics and targets; 2) peer groups used to benchmark pay; and 3) payments following a change in control.

Moody's believes that well articulated performance targets provide insight into the aggressiveness and risk profile of a company. Peer group selection reveals how a company perceives itself, and whether the board is exercising disciplined oversight of pay benchmarking in particular. Finally, change in control payouts and terms provide insight into the incentives (or lack thereof) management teams may have for pursuing strategic alternatives that can be transformative events for creditors, such as business combinations.

<sup>1</sup> A User's Guide to the SEC's New Rule for Reporting Executive Pay, April 2007 (102762)

<sup>2</sup> SEC Staff Observations in the Review of Executive Compensation Disclosure (SEC Website)



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This report discusses why these cited areas are important to credit quality, what the SEC has said about them, and the red flags that investors should consider when evaluating these compensation elements under the new disclosure rules. Moody's plans to follow this report with comments on compensation trends and Supplemental Executive Retirement Plans (SERPs).

### Analysis

#### Performance metrics and targets

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Understanding the performance metrics and targets that drive incentive pay is useful to credit analysis because:

- Performance metrics are a window into management decision making
- Performance targets are a guide for risk tolerance
- Managers may be inclined to pursue strategies that maximize payouts under incentive plans

Pay metrics create incentives for executives to engage in behavior that can be either beneficial or detrimental to creditors, depending on the metric. Incentive pay metrics tied to cash flow or return on investment, for example, are generally good for creditors, because they provide an incentive to maximize funds available to service debt. However, metrics tied to earnings per share (EPS), for example, might put excessive focus on share repurchases, or debt-funded acquisitions aimed at revenue growth, management decisions not always as favorable to creditors.<sup>3</sup>

Disclosure of the actual numerical targets can be a useful indicator of the board's risk tolerance. The actual targets are useful in understanding how aggressive management will need to be to achieve the target. The targets are also a useful measure of how difficult it will be for managers to achieve the maximum payouts.

Quality disclosure of performance metrics and targets facilitates better insight into management decision-making because it illustrates the behavior the board wants to see from management. In that vein managers will pursue strategies in order to maximize their performance payouts.

Continuing a battle that pre-dates the new rules, the SEC is pushing issuers to provide more detailed disclosure regarding the financial metrics and targets used to calculate annual bonus and long-term incentive pay for named executives. Under the new rules, issuers are required to disclose targets used to calculate pay. If they do not, they must demonstrate to the SEC that disclosure of the targets could cause the company competitive harm. Even if the targets are not disclosed, issuers are required to characterize how difficult it will be for the executive or how likely it will be for the company to achieve these targets.

Some red flags that investors may wish to consider include: too many performance metrics ("laundry list"); overly complicated metrics; or lack of discussion about the probability of achieving performance compensation. These red flags could be an indication of an undisciplined pay-setting process. The level of detail and discussion about executive pay in company disclosure can speak to a board's culture of openness, or lack thereof. Poor disclosure impedes the ability of investors and analysts to interpret potential implications of pay for bondholders.

That said, Moody's found that some companies did do a better job of disclosing performance metrics and targets including, for example, specific ranges for the funding measure for the annual incentive plan and specific language around measures that would reduce the overall annual incentive.

<sup>3</sup> U.S. Executive Pay Structure and Metrics, June 2006 (97887)

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### Peer groups

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Improved disclosure of peer group composition provides insight into the board's process of benchmarking executive pay against appropriate peers. The SEC has made clear that it expects improved disclosure around what peer groups are used to benchmark pay when the peer group is a material factor in setting pay levels. As a result, Moody's found more issuers to have more useful disclosure regarding peer group benchmarking, though there is room for improvement among almost all issuers.

Here are some red flags to look for when assessing peer groups:

- Too many firms listed (more than 15)
- Bias toward "peers" that are substantially larger and/or more profitable
- Multiple peer groups with unusually high CEO pay, particularly if not direct competitors
- Too many industries and geographic markets included
- Peers that do not compete with the issuer for executive talent
- Unexplained year-to-year peer group changes

These red flags can be a concern to investors because of the potential to "game" the pay-setting process. For example, a company may select a peer group composed of companies that are substantially larger than itself; that set a high percentile pay target (75<sup>th</sup> percentile or greater); or that operate in a more profitable sector. This practice can indicate an undisciplined pay-setting process and weak board oversight.

That said, some companies provided useful peer group disclosure in the 2008 proxy statements, including key factors about the peer group like revenues, asset size and number of employees.

### Severance following change in control

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Disclosure of hypothetical severance payouts to named executives under various scenarios, including following a change in control, is now required under SEC rules. This expanded disclosure may provide valuable insight into which managers have unusually strong incentives, relative to peers, to pursue a change in control such as a merger. The disclosure could be of particular interest to bondholders that do not have covenant protection against deterioration in credit quality due to a change in control, especially one that results from a debt-funded business combination. These disclosures can be especially useful when a company has shareholder activists who have targeted it for strategic changes.

Most issuers in 2007 used a tabular format to detail severance payouts to each named executive under different scenarios, including termination following a change in control. The SEC complimented the use of tables, which should help to generate even more uniform disclosure in 2008.

### Other useful disclosures

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Some companies provided disclosure that went beyond what was required by the rules and were useful from an analysis perspective. Two such areas were disclosures on internal pay equity and wealth accumulation.

#### Internal pay equity

One area of pay on which institutional investors are increasingly focused is the difference in pay between the CEO and other senior managers, sometimes referred to as "internal pay equity". This is essentially the ratio of pay between the CEO and the CEO's direct reports. A large ratio can be a possible sign of "key person risk" or a weak board.

While we do not argue that companies should set up specific pay ratios between executives we do note that at larger companies generally, the pay level for the second highest paid executive is about half of the CEO's total direct compensation. In our view, a large disparity in internal pay equity (greater than three times the amount

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received by the executive second in pay, for example) may indicate underdevelopment of management succession planning, and concentration of power in the CEO. These factors pose a substantial succession planning challenge and some key person risk for the company at the CEO level. We think it is useful for boards to engage in this type of analysis as it provides a level of comfort that the board is exercising its role in succession planning and evaluation of the CEO's progress.

Although many companies review internal pay equity when determining compensation levels, companies are not required to include a discussion of internal pay ratios in the proxy statement. However, a number of companies, like ConocoPhillips, Amgen and Intel, have taken the extra step to include this type of disclosure, which is a positive step in complying with the spirit of the enhanced disclosure requirements and is useful information for compensation analysis. Each of these companies provided a brief discussion on the total pay ratios between the CEO on other named executives.

### Wealth accumulation

Another area investors have voiced concern over has been the total wealth accumulation of named executives, especially the CEO. We believe it is useful for compensation committees and boards to engage in a discussion about the total amount of wealth transfer given to an executive, commonly referred to as the "tally sheet". A long tenured CEO, for example, may have accumulated a significant amount of equity. This can call into question the need for further large equity grants as a motivational factor. It is also helpful for the investor to understand the value transfer, and investors gain comfort from disclosure that these issues are raised in the compensation committees. A number of companies, including Kellogg and DuPont, have disclosed the board discussion around tally sheets.

### Future compensation disclosure challenges

One of Moody's original concerns about the enhanced disclosure rules, echoed by the SEC, was that the legal burden attributed to filing the Compensation Discussion and Analysis (CD&A) would encourage companies to veer towards legalese and boilerplate disclosures. Overall we believe there is room for further improvements in the conciseness of the CD&As and embrace of "plain English". That said, we did see improved disclosure in the 2008 proxy statements in certain areas helpful to credit analysis.

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### Moody's Related Research

#### Special Comment:

- Western European Executive Pay Disclosure Trends Bode Well for Better Credit Analysis, December 2007 (105837)
- Analyzing Unexpected CEO Departures and Severance Payouts for Signs of Weak Governance, December 2007 (105930)
- A User's Guide to the SEC's New Rules for Reporting Executive Pay, April 2007 (102762)
- U.S. Executive Pay Structure and Metrics, June 2006 (97887)

*To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.*

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