



**Project Report**

MBA 695O: Corporate Governance Instructor: Janis Riven

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# Executive Summary

## Goal Definition

Make a recommendation to Concordia University Pension Fund whether to invest or not in Air Canada’s company, knowing that they are interested in sustainable and ethical organizations.

## Corporate Governance

* Proxy voting is possible in several ways: mail, fax, internet
* Air Canada has their auditors since 1990, best corporate governance practices suggest to switch auditors to keep neutrality and independence
* Number of directors (10) and number of meeting per years (10) are reasonable
* Directors tenure have an average of 4.6 years in the board, which is good
* 8 directors out of 9 are independent, the board being a majority independent
* There is only one woman on the board

## Risk Management

The nature of the Airline industry is risky. Therefore, a systematic risk management is of great importance to this business. This system should comprise of an established process and sufficient number of qualified people at each level of the organization (including the board), to execute it. This process should be applied across the entire enterprise, designed to identify potential events and to manage the risks identified. It should be able to provide reasonable assurance, and be geared to achievements of objectives. In Air Canada, there is a system in place to identify risks, however how comprehensive this system is and how qualified the people are, is questionable [1].

## Corporate Social Responsibility

Air Canada’s corporate sustainability report was first issued in 2011 and the latest issue, Citizens of the World was issued covering the year 2012 [2], approved by the corporate governance’s committee, the document focuses on four main areas of sustainability defined based on internal and external surveys: safety, the environment, employees and community.

There are several initiatives that Air Canada has undertaken in support of Corporate Social Responsibility goals; however, many of them are merely a result from initiatives with other incentives such as cost cutting. The report also lacks information and explanation about some major incidents occurred during the year within the areas of Corporate Social Responsibility and merely focuses on initiatives and events with positive impact.

# About the company

Founded in 19361, Air Canada is the largest Airline of the market in Canada. The company operates four hubs in Canada: Toronto, Vancouver, Montréal and Calgary, offering 1500 flights to over 326M people in 2013. Air Canada is split into 4 subsidiaries:

* Air Canada Express: Brand used for traveling passengers through independent airlines including Jazz Aviation, Sky Regional Airlines, Exploits Valley Air Services and Air Georgian.
* Air Canada Rouge: Discount traveling servicing leisure routes
* Air Canada Cargo: provides cargo services
* Air Canada Vacations: offers leisure complete travel packages including tours, cruises and vacations, etc.

Air Canada is a member of Star Alliance network that includes twenty-eight airline members affiliated with Aeroplan. Their corporate strategy focuses on four key elements to succeed in the airline market: cost transformation and revenue improvement, international growth, customer engagement and culture change.

# Corporate Governance

## Shareholder relations

The company makes an effort to facilitate quarterly meetings by renting space at the ICAO downtown rather than holding them in their headquarters at Trudeau International Airport. Furthermore, proxy voting is made possible by mail, fax, and via internet

## Auditors

AC has been using PWC LLP as Auditor since April 1990. Although there are no doubts in the quality of the audit work, best practice suggest to switch auditors from time to time to insure auditor neutrality and avoid friendships being built between the auditors and auditees, which could potentially result in conflicts of interests.

## Board

Although a majority of withholding votes for a director does require submission of resignation, the board holds the right to overrule the vote and keep the director if deemed appropriate. Both the number of directors (10) and meetings per year (10) are reasonable, as well as the turnaround in board tenure (Average 4.6 years) and board independence (9 out of 10 independent directors; the non-independent being the CEO). There is a retirement policy (age 75), but just like majority voting, the board reserves the right not to apply it. In the advent of director turnaround, there is a nomination committee with guidelines for nomination, and, according to the proxy, the board formally discusses and reviews succession planning of all executives.

Last year, members posted almost perfect attendance; only 1 director missed one meeting last year. Directors are encouraged to follow continuous education, and their attendance to training is disclosed in the proxy.

## Compensation

Like most corporations, AC performs industry benchmarking to adjust compensation according to peers included in the review. The Government of Canada recently passed legislation to cap executive pay in order to help fund the pension plan. The company promotes variable compensation to align behavior with corporate strategy, there is a clawback policy in place (adopted in 2011), and there is clear disclosure of compensation granted, accomplishments and targets used for executives.

##

## Executive Compensation

Executive salaries have been frozen by the Government in a recent deal to address the pension solvency issue. Even with this cap on salary, the CEO was offered a 5M$ retention bonus in 2012. This bonus was not tied to any performance KPIs but rather an unconditional hiring contract clause to be paid out if he remained employed for at least 3 years. Although the practice is legal, the verbiage used in the 2013 Proxy to disclose this bonus raises questions in terms of accountability of the board, more specifically the statements: "The recruitment of top corporate executives, including the CEO, is very competitive. [...] the Board of Directors was advised by an independent third-party consulting firm as to the terms of his compensation".[3,4]

# Risk Management

## Introduction

Due to the nature of the business Air Canada is exposed to a variety of risks in all four objective categories of Strategic, Operations, Reporting and Compliance. The risks identified by the company are industry, market and competition; economic and geopolitical conditions; ability to reduce operating costs and secure financing; energy prices; forex and interest rates; employee relations; pension issues; war; terrorist acts; epidemic diseases; environmental factors; insurance issues and costs; seasonal nature of the business; supply issues; laws/Regulatory developments; pending and future litigation and actions by third parties; interruption and disruption of the services and liquidity.

Although, these risks are addressed to some limited extent in the MDA report, the topic of risk is not systematically discussed within MD&A or Management Proxy.

## Internal and External Risks

The following is a categorization of risks based on the ability of the company to impact their occurrence:

|  |  |
| --- | --- |
| **Internal Risks** | **External Risks** |
| The ability to reduce operating costs and secure financing,Employee and labour relations,Pension issues,Insurance issues and costs,Liquidity | Industry, market and competition,Economic and geopolitical conditions,Energy prices,Currency exchange and interest rates,War/ Terrorist acts,Epidemic diseases,Environmental factors Insurance issues and costs,Changes in demand Supply issues,Changes in laws / Regulatory developments |

## Risk Analysis

Industry, market and competition: Air Canada operates in an industry that is very capital intensive, fixed costs are high, competition is fierce and customers are very price sensitive.

Economic and Geopolitical Conditions: Since the nature of the business involves operation in both high-growth and weak economic environments, Air Canada needs to invest significant resources in monitoring consistently global economic evolution.

Energy Prices: Aircraft fuel has accounted for approximately 30% of the company’s opex in 2013, and Oil prices are extremely volatile. Even though the company can mitigate the risk by hedging with futures contracts, volatility and raising energy prices is a significant threat to the business.

Currency exchange and interest rate: Air Canada is vulnerable to interest rate fluctuations because of the capital intensity nature of the business and to forex rates since it needs to operate globally. Like oil prices, these risks can be hedged short term by future contracts but might eventually impact the business after contract expirations.

War: For obvious reasons, war can generate instability and disrupt operations in sensitive regions. Although the company cooperates with various governmental organizations to stay informed, potential war liability is a risk that can materialize unexpectedly.

Terrorist Act: The impact on the business is very high, but currently terrorist acts on airlines occur at low frequency since the implementation of after 9/11 counter-terrorism measures.

Epidemic disease: Although a risk, airlines do not typically incur liability for transporting diseases. This is more a lost revenue risk with a fairly low probability of occurrence, therefore it is not monitored closely by the board.

Environmental factors: Air Canada earns around 60% of its revenue from flights within Canada and the US, where bad weather in the winter can adversely affect operations.

Insurance issues and Costs: Currently, the GoC provide an indemnity for third party war risk liability, expiring in 2015. There is a possibility that is not renewed.

Changes in demand: This is mostly due to the seasonal nature of the business, and although directly impacts the top line, can be predicted with fair accuracy.

Supply issues: If materialized, this risk, in addition to put pressure on the company’s financial situation can cause a safety risk if not properly managed. Due to the variety of the supplies, and the numerous suppliers that Air Canada is dealing with, the supply issues are very frequent issues.

Changes in laws, regulatory development or proceedings: Any new regulatory requirement can generate significant compliance costs to the airline. Their frequency is not high enough to be considered as a key risk, and additionally, they rarely happen suddenly. Also, the recent adoption of Carbon Cap & Trade could have significant short term impacts on the company’s bottom line.

Employee and labor relations: With recent post-bankruptcy restructure and conflicts over pension deficits, bad employee relations are a permanent threat to the company’s operations.

The ability to reduce operating costs and secure financing: Since the industry is very capital intensive, Air Canada’s ability to reduce operating costs and secure financing can play a key role in the success of the firm.

Pension issues: Since early 2000’s bankruptcy and restructure, the company has still been struggling to address the 4B$+ deficit in employee’s pension fund. An agreement has been reached with the GoC, requiring the company to inject significant $s into the fund until 2020, but by then there could still be some liability left to disburse.

Liquidity: If the company falls victim to major accident or continues to collect bad press regarding employee relations, financing could become more difficult potentially resulting in liquidity issues.

Interruption or disruption in services: Delays or disruptions in service, because of incidents, safety issues, technical issues, air traffic, etc is very costly to the Airline. Since the factors that might cause interruption or disruption are various and are sometimes beyond the control of the Airline, the probability of this issue is very high. [3,4]

## Company’s Strategy to Manage Risk

The populated key risk area in the Risk Analysis Table in Appendix 1 highlights the importance of risk management in each level in this business. The following table provides a better understanding of the company’s risk management by showing if each particular key risk (identified above) is identified at management level and board level, and whether there is a risk management system in place at each level:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Risk | Mgmt | Details | Board | Details |
| Industry, market and competition | Y | 1. Close monitoring of the competition
2. Reduce yield and fares
3. Loyalty program
4. Establishment of Air Canada Rouge
5. Partnership with low-cost airlines
6. Systematic cost reduction
 | N | There are some training and lectures presented to the board on the market and competition. |
| Economic and geopolitical conditionsChanges in demand due to seasonal nature of the business | Y | Indirectly addressed1. Diversification (Air Canada rouse)
2. Partnership
3. Cargo and passenger freight
 | N | Board members are expected to have knowledge and understanding of the industry and the geographical areas, which does not necessarily include risk management skills in this area |
| Energy pricesCurrency exchange and interest rates | Y | 1. Use of various interest rates, foreign exchange, fuel and other derivatives
 | Y/N | Foreign currency exchange issues are monitored by audit committee and recommendations is provided |
| War | Y | ***No process in place*** | N |  |
| Environmental factors | Y | ***No process in place*** | Y | Audit & Risk Management Committee |
| Insurance issues and costs | Y | ***No process in place*** | Y | Audit & Risk Management Committee |
| Supply issues | Y | 1. Diversification to some possible extend

On some supplies there are not many options available to diversify | N | The oversight of this risk might be considered the responsibility of the Audit and Risk Management committee categorized under “Other” risks |
| The ability to reduce operating costs |  | 1. Managing the fuel cost
2. Management of labor relation and cost

***No other measure is in effect, like improving the processes*** | N | The oversight of this risk might be considered the responsibility of the Audit and Risk Management committee categorized under “Other” risks |
| Employee and labor relation | Y | 1. Agreement with unions
2. Outsourcing
3. Layoffs
 | N | This can be considered as cross-responsibility of both Audit & Risk Management committee and HR and Compensation Committee. It is not clarified  |
| Pension | Y | 1. Long term interest rates
2. Investment return on plan assets
3. Agreements with the government
 | Y | HR and Compensation Committee |
| Liquidity | Y | 1. Preparing rolling cash flow tolerances
2. Monitoring the condition and value of the assets available to be used and those used as security in financing arrangement
3. Maintain unrestricted liquidity of $1.7 billion
 | N | This might fall under Audit and Risk Management committee to ensure the company’s ability to meet its liabilities. But it is not clearly mentioned in the committees roles and responsibilities |
| Interruption or disruption in Services | Y | ***No process in place*** | N | Audit Committee is responsible for overseeing the risk associated to computer failures which could be one cause of interruption or disruption. |

It can be derived from the above table that the management team has been able to identify most of the key risks and put a mitigation and risk management process in place to address most of them. However, there is not an effective and clear oversight process in place from the board. The following issues have been identified with the board of directors’ risk management system:

1. The nature of this business is risky. The number of key risks identified is a support to that idea. Therefore it is expected that the board has a systematic process in place to control and manage the risk and oversight the management strategy and mitigation performance in this regard.
2. It is not very clear which committee is managing all these risks. It is mentioned that the Audit and risk management committee is responsible for risk management. From the information provided in the management proxy, it is perceived that mostly the risks associated with the financial reports are going to be managed by the Audit Committee. And, the Human Resource committee is managing the risks associated to the pension. But there is no specific material regarding the other key risks
3. Effective risk management is a key factor in this particular business. A separate risk management committee composed of qualified people seems to be necessary to effectively monitor these risks.
4. The risk management practice of the executives is taken into account by the HR committee, while analyzing their pay. However, there is no director in HR committee with sufficient risk management experience to be able to assess that expertise. In general, there is no director on the board with experience in risk management. The only person whose resume covers some information about expertise in risk management is Ms. Annette Verschuren, who is a member of Audit and Risk Management committee. Furthermore, it is not clear in which field her risk management expertise lies. She has experience in retail industry, and it is perceived that her risk management expertise is in financial reporting and audit.
5. The Audit and Risk Management Committee met only 4 times during 2013. This number for such a risky business is of great concern.

## Conclusion

To assess Air Canada’s Enterprise Risk Management Process, the COSO’s guideline is used.

|  |  |  |
| --- | --- | --- |
| COSO 2004 Guideline | Air Canada Assessment | Comment |
| Aligning risk appetite and strategy | NC | Risk appetite is not discussed in evaluating strategic alternatives, or sufficient information is not provided to justify this performance. |
| Enhancing risk response decision | NC | For any risk management/mitigation process in place the rigor is not provided to assess the risk responses/mitigation plans. |
| Reducing operational surprises and losses | PC | This item is partially exercised, but does not cover all the identified key risks. |
| Identifying and managing multiple and cross-enterprise risks | PC | These risks are partially identified and addressed. |
| Seizing opportunities | PC | This is done only partially, because for example there is a high risk of war in the Middle East, and the corporation has initiated a direct flight to Tel-Aviv. |
| Improving deployment of capital | C | Since bankruptcy, the company has made significant shifts both in corporate and capital structure; the topic is constantly monitored and results are starting to materialize with the recent move to profitability |

C: Compliance, PC: Partial Compliance, NC: Non-Compliance

[1, 3, 4]

# Corporate Social Responsibility (CSR)

Air Canada’s corporate sustainability report was first issued in 2011 and the latest issue, Citizens of the World was issued covering the year 2012 [1], approved by the corporate governance’s committee, the document focuses on four main areas of sustainability defined based on internal and external surveys: safety, the environment, employees and community. The report is covering many initiatives in each of the four areas supporting the CSR goals; however, it is not addressing some of issues and lacks a more thorough explanation about certain initiatives.

With regards to safety, procedures are in place to ensure tight safety standards, however, many of the initiatives are undertaken in order to comply with the minimum requirements set by regulations, or to maintain registration to recognized organizations like IATA. Only one third of employees participated in Safety Pulse Survey, which is a very low rate. No information has been provided to address this low participation rate, which could be a sign of employee dissatisfaction.

With regards to the impact on the environment, many initiatives are listed under CO2 reduction, which are primarily focusing on reaching economies of scale, achieving efficiency, cutting cost and lowering fuel consumption, the Air Canada’s largest expense. There have been only two revenue flights suing biofuel operated in 2012 by Air Canada.

About 90% of the employees are unionized and have an average age of 44. Air Canada’ union environment creates challenges to motivate and empower employees based on results and performance. Labor troubles and pension obligations resulted in problems with unions and consequently considerable cost. After instances of many strikes and lockouts, unhappy employees were banned from strikes by legislation. This resulted in other actions undertaken by employees to show their dissatisfaction, for example when 75 flights were cancelled when dozens of pilots called in sick in 2012 [1].

It is mentioned in the CSR report 2012 that in order to support its foundation to improve delivery of charitable initiatives, Air Canada planned to establish an employee payroll deduction plan in 2013. Detailed information is not provided about the implementation plan and employees’ consent to absorb the cost and it seems to be a cost pushed to the employees.

In March 2012, Aveos Fleet Performance Inc. Air Canada’s subcontractor went out of business, following a decline in business from Air Canada who gave a 5 year renewable contract to AAR, an American company that would maintain its airplanes with 350 workers, putting 2,600 people out of work in Manitoba, Ontario and Quebec [5]. From cost reduction perspective, it is justifiable to outsource support services abroad to countries that can carry the work cheaper and more efficient however these initiatives demonstrates lack of support for local society and economy.

It is mentioned in Air Canada’s 2013 MD&A that as part of Air Canada’s initiative to reduce cost and increase efficiency and competitiveness, new high density Boeing 777 have been introduced into Air Canada’s. This initiative has a positive impact in reducing fuel consumption and consequently CO2 emission per passenger per flight, however, the main incentive is to increase Air Canada’s profit. This saving on cost is not being translated into price reduction and hence customers eventually bearing the cost for their decreased comfort level.

Air Canada rouge has been launched on July 2013 to enhance margins on leisure routes through its competitive cost structure, however, one of the main elements that enables lower cost operation is lower wages which shifts the costs to employees.

 To conclude, there are several initiatives that Air Canada has undertaken in support of Corporate Social Responsibility goals, however, many of them are merely a result from initiatives with other incentives such as cost cutting. The report also lacks information and explanation about some major incidents occurred during the year within the areas of Corporate Social Responsibility and merely focuses on initiatives and events with positive impact. The report should address these big incidents and provide justification for these decisions and demonstrate exercise of care with regards to the consequences of the decisions and provide a comprehensive action plan to mitigate the negative impact.

# Financials

## Dual Class Shares

The company does have shares with variable voting rights, but it does not follow the common “Family business” model. Class A and Class B have identical terms except that Class A (variable voting shares), have voting limitations for foreign owners. Investors can’t choose to buy A or B Shares; a Canadian purchasing a Class A share will effectively convert it to a Class B and a foreigners purchasing a Class B will convert it into A. The main difference is that for Class A variable voting shares, one share provides one vote unless ownership of Class A shares exceeds 25% or that there are more than 25% of Class A shares that exercise a vote, in which case the weight of the Class A shares vote will be scaled to 25% and the weight of Class B shares increased accordingly. This system was implemented to comply with the Air Canada Public Participation Act (ACPPA) and Canada Transportation Act (CTA), most likely to ensure that the company is not controlled by foreigner who could be tempted to cut on safety/environment without material attachments to the social cost of potential accidents (ex: Like MMA in railroads).

The price of both classes is roughly identical, with a tendency for a slightly higher share price for Class A.

## Share Performance

Since IPO back in 2007, the share price has significantly decreased. The pronounced decrease in 2007 can potentially be attributable to the spike in oil process, and the 2008 decent attributable to the global recession



Figure 1: Share price since after bankruptcy IPO in 2007

Following this decline, the CEO was replaced with the current CEO, Calin Rovinescu, was appointed in Q2 2009, and has experience having been AC’s Chief Restructuring Officer following the bankruptcy protection. Since his appointment, the stock has been keeping at par with competitors, until mid-2013 when the company posted its first profitable earning statement since 2007 and started to significantly over perform its commercial rivals.



Figure 2: Share performance relative to competitors since appointment of new CEO in Q2 2009

Overall, the company is posting slow revenue growth. Although operating income has been positive since 2010, the Government had passed the Air Canada Pension Plan Funding Regulations in 2009, requiring the company to make significant contributions to defined benefit pension plans. The company came to an agreement with the GoC to fund the pension plan until 2020; the company will have to make payments of at least 150M$ into the fund, with an average of 200m$ annually in order to provide an aggregated 1.4B$ into the fund. Although this is a significant injection of cash into the fund, the pension solvency deficit is estimated to be around $4.2B, therefore, there is a high possibility of further liability.

Although currently (or at least last year) profitable, the company still has an accumulated deficit of 2.3B$, not taking into consideration pension fund liabilities. [7,8]

# Recommendations

Based on the analysis provided in this report, we do not suggest Concordia University Pension Fund to make an investment in Air Canada funds. First, Air Canada has an important liability regarding pension fund increasing risk for investors. Second, there is a potential liability of Air Canada by the carbon tax cap & trade in this industry where pollution is very high. Third, there is no hedging possible forever in airlines industry due to increasing oil prices. Fifth, the various number of the key risks in place are systematically managed, which can cause a lot of problems. Concordia University is interested in sustainable organizations and Air Canada is in a polluting industry and there is no incentive for the company to innovate in environmental foot print reduction at the moment, but only if related to cost savings which is not the case.

Moreover, there are tense employee relations and unresolved issues with the union that does not help the company to have stimulated and motivated employees to perform.

Since bankruptcy in 2013, they are only starting to make profits, and there is no proven track record of financial performance, so investing in Air Canada is uncertain and risky.

To conclude, Air Canada applies a majority of good corporate governance practices, but is not, by far, the most sustainable and ethical organization and this is why Concordia University should not invest in this company.

# References

[1] Committee of Sponsoring Organizations of the Treadway Commission (COSO) USA 2004

http://www.coso.org/documents/coso\_erm\_executivesummary.pdf

[2] http://www.aircanada.com/en/about/corp\_sustainability.html

[3] 2013 Management’s Discussion and Analysis of Results of Operations and Financial Condition

[4] NOTICE OF 2013 ANNUAL MEETING OF SHAREHOLDERS AND MANAGEMENT PROXY CIRCULAR

[5] http://www.cbc.ca/news/business/air-canada-to-appeal-quebec-court-ruling-on-aveos-1.1402818

[6] Corporate Website / Investors Relations: <http://www.aircanada.com/en/about/investor/>

[7] Google Finance: <https://www.google.ca/finance?cid=713629>

[8] Sedar Public Company Documents: <http://www.sedar.com/search/search_form_pc_en.htm>

# Appendices

## Appendix 1 – Risk Analysis Table

Industry, market and competition

Economy and geo-political conditions

Energy prices

Currency exchange and interest rates

War

Environmental Factors

Insurance issues and costs

Changes in demand due to the seasonal nature of the business

Supply Issues

The ability to reduce operation costs

Employee and labor relation

Pension

Liquidity

Epidemic Diseases

Terrorist Act

Likelihood to happen

Impact on the business

Changes in laws and regulations

Customer cancelation, Overload happening, etc

Interruption or disruption in service

## Appendix 2 – Income Statement for the past 3 years

