

ViewPoints

The economic and financial crisis: implications for the compensation committee

Members of the Compensation Committee Leadership Network met on February 5, 2009, in New York to share their thoughts on the unique challenges facing compensation committees in the current economic and financial crisis. A portion of their discussion was informed and enlivened by special guest Michael Chae from The Blackstone Group. Members also engaged in a joint session with members of the Audit Committee Leadership Network to consider the intersections of risk and reward.

The following members participated in the meeting:¹

- Dina Dublon, Microsoft Corporation
- David R. Goode, Caterpillar Inc. and Delta Air Lines
- Stephen P. Kaufman, Harris Corporation and Thermo Fisher Scientific
- Peter M. Miterko, Hewitt Associates
- Michael J. Powers, Hewitt Associates
- Willem P. Roelands, Applied Materials
- Stephen W. Sanger, Wells Fargo
- Daniel H. Schulman, Symantec
- Samuel C. Scott III, Motorola
- Laurie Siegel, Embarq Corporation

The following members took part in pre-meeting discussions but were not able to attend the meeting:

- John L. Anderson, Hewitt Associates
- Lewis W. Coleman, Northrop Grumman
- Michael J. Critelli, Eaton Corporation
- Thomas J. Donohue, Union Pacific Corporation
- Robert J. Lawless, Constellation Energy Group
- William D. Smithburg, Abbott Laboratories and Smurfit-Stone Container Corp.
- Wesley W. von Schack, The Bank of New York Mellon
- Jonathan P. Ward, Sara Lee Corporation

ViewPoints reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations. Quotes in italics are drawn directly from members of the Compensation Committee Leadership Network.

¹ The compensation committee chairs are identified by their board membership. Peter Miterko and Michael Powers participated in their capacity as compensation experts.

Executive summary

Members are acutely aware of the severity of the current economic crisis: corporate earnings have suffered; layoffs have escalated; real estate values are down significantly; the banking sector is being fundamentally restructured; liquidity and credit have vanished despite massive government infusions of cash and a federal funds rate near zero; and consumer spending continues to plummet.

As external factors impact corporate performance, compensation plans are coming under considerable pressure. In response, compensation committees are searching for ways to reassess and reengineer the design of compensation plans. In this dynamic context, CCLN members shared their experiences, perspectives, and insights in four broad areas:

- **Responding to the current economic and political environment.** Members predict that heightened scrutiny of executive pay, combined with a new administration, the far-reaching provisions of the bailout bills, and emboldened shareholder activists will apply significant political and regulatory pressure on compensation committees in 2009. Although members maintain that say-on-pay is a “*blunt instrument*,” they accept that its ratification is inevitable and so are choosing to focus on other, higher-priority issues. They continue to monitor legislative developments in the wake of the October 2008 Emergency Economic Stabilization Act and anticipated passage of the American Recovery and Reinvestment Act of 2009.² Some are hopeful that new legislation – or just the debate it sparks – will encourage compensation committee chairs to take a more assertive position on compensation plan design going forward. In fact several members agree that the current crisis presents an opportunity to fundamentally rethink compensation plan design for the future, particularly for companies in financial services.
- **Designing compensation plans in 2009.** Members discussed several key areas of compensation plan design for 2009, including long-term incentive plans, targets, peer-group comparisons, and severance agreements.
- **Private- versus public-company approaches.** Some observers of corporate governance believe that the boards of privately held companies have a performance advantage gained in part through their hands-on approach to executive selection, development, and evaluation; alignment of goals; and incentives and compensation. Others are not so sure. Our members acknowledge that there are significant differences between the way public and private companies design compensation. From their conversation with Mr. Chae, they came away with an understanding of several important concepts and practices that public companies can learn from the private sector, among them the value of spending more time on issues, of focusing on strategy versus compliance, of thinking about compensation as a percentage of profit, and of having staff support.
- **Joint considerations for audit and compensation committees.** Members of both the ACLN and CCLN recognize that there are a number of areas in which board performance can be improved through greater collaboration between audit and compensation committees. At the meeting they discussed three of those areas: addressing underwater stock options; setting performance targets and determining quality of earnings; and finding ways to engage the full board and each committee.

² President Obama signed the bill into law on February 17, 2009.

Responding to the current economic and political environment

Compensation committees have been hard at work designing fair and effective pay plans at a time when total shareholder return is negative, future operating performance cannot be predicted with reliability, and most short- and long-term incentive plans are not even close to paying out. Complicating matters, executive compensation in the financial sector, where rewards for earnings performance in past years often were paid well before risks became apparent, has triggered intense anger among legislators and shareholders – anger that is spilling over into every other sector.

Surveying the economic landscape in 2009

Despite both the current and the previous administrations' attempts to stabilize the economy, members agree that they continue to be *"in uncharted territory."* Many members predict that the economy will continue in its downward decline:

- *"It does seem that finding the bottom is going to [take longer] than we thought. There have been wave after wave of job losses announced, and that's going to precipitate other losses down the road. I think it's going to be a while before we really know where the bottom is."*
- *"History shows that recovery from bubbles [bursting] takes a long time because fundamentally the trust [in the economy] is lost, and it's going to take a while to build it back up. My mindset hasn't changed much [since we last met in October]. I still think this recession is going to take a while to play out."*
- *"The economy is in rough shape, and the packages aren't paying out the way they used to. It has been an extremely difficult couple of months."*

Members report that employee motivation and retention are two of their greatest concerns: *"How do you keep people motivated? Things seem a bit out of control, and management feels they're working harder than ever and getting less and less reward."* That feeling is likely stronger when a company has undergone a large acquisition. Explained one member: *"The management team would be managing a company that's significantly larger, and they would have a very challenging task ahead of them. Normally you would reflect that in pay. Yet now the public mood on compensation is so universally bad that I'm not sure what you would do."*

Many members believe that one of the major outcomes of the recession will be a shift in the mindset of the *"engine of the economy"* – the consumer: *"I think we're in for a fundamental change ... I think people have been shattered by the twin rocks of stability: 401(k) and home equity. I think the memory of this [recession] – even if things start to come back – will weigh heavily on the consumer for the foreseeable future. I think there's going to be a fundamental shift in the consumer mindset, and I think it's going to stay that way for a long time."* Moreover, many members predict that *"the other shoe has yet to drop."* They foresee additional job losses, steeper declines in commercial real estate values, increasing problems for credit card companies, and price-to-earnings ratios that may never return to pre-crisis levels.

Not all CCLN members cast such a dire outlook on the economic environment: *"We all have short memories. The world has changed since the [last significant recession in the] 1980s. Money is now coming in from other parts of the world. Yes, this year is going to be horrendous ... but I believe we'll make it. I do think things will bounce back. Even as we go through the bottom of the cycle,*

some indications we're seeing show that maybe – just maybe – we'll start to come back sooner than people think."

Indeed some are even predicting that certain companies will emerge stronger for the current crisis: *"There's going to be a tremendous weeding out of the winners and losers. Some are going to emerge with dominant market positions [as a result of the recession]. As retailers fall away, other larger companies will come out stronger than they were before. They ought to have the same amount of appeal – if not greater – than they did before."*

Seizing the opportunity to re-assess executive compensation

Among the members who believe that the economic downturn will produce a fundamental shift in the mindset of consumers are those who predict a shift in the mindset of executives too. Said one: *"I see executives being really pained by all of these layoffs. Yes, we all predicted this would be bad and bad for a long time, but now it's looking even longer. I think executives might be changing their expectations around the kind of wealth they will earn over their [work lives] and retire with. Hard to say now, but that might be ultimately what changes the way we pay."* Added another member, *"I think this could be a great opportunity to remove the Lake Wobegon syndrome."³*

Some members also see an opportunity to re-assess the way specific industries have historically designed executive compensation. In particular, members emphasize the possibility of a "reset" for investment banks: *"This is a real opportunity to fundamentally redesign compensation plans at investment banks. I hope they are wise enough to go for that opportunity."*

Responding to regulation and legislation in 2009

The combination of a new administration, an emboldened Congress, bailout bills with far-reaching provisions, and heightened shareholder scrutiny will bring even greater political, regulatory, and public relations pressure to bear on executive compensation in 2009. Say-on-pay legislation and the economic stimulus acts have emerged front and center as members consider potential legislation and its implications for the upcoming proxy season.

Say-on-pay is "not the hill to die on"

Although it comes as no surprise to CCLN members, say-on-pay is promising to again be a hot-button issue in the upcoming proxy season. Proposals mandating say-on-pay were endorsed by President Obama when he was in the Senate, and members agreed at the February meeting that *"there is no question that say-on-pay will soon be the law."*

In light of that inevitability, the tone of CCLN members has changed: *"I think say-on-pay is much ado about nothing in reality. My view is that this is the wrong hill to die on. There are other issues I feel more strongly about. Say-on-pay is going to happen anyhow. It's going to happen, and I don't want to waste any more of my time worrying about it."*

³ "Lake Wobegon syndrome" refers to an environment in which everyone is perceived to be "above average." Lake Wobegon is the fictional setting of comedian Garrison Keillor's radio show *A Prairie Home Companion*.

While the tone may have shifted, the attitude of CCLN members toward say-on-pay legislation remains the same:

- *“I think say-on-pay is a bad idea just because it raises questions like ‘Should there now be say-on-investment?’ ‘Say-on-junket?’ These are operating decisions. Why choose this issue just because it happens to be high profile? It is not helpful to management or the company.”*
- *“We’re accepting of say-on-pay because it doesn’t have any real effect. However, the next step might be ‘Let’s approve certain plans in advance.’ Then we’d have an issue. I’m not fighting say-on-pay anymore; I just want to know if it’s going to cause other issues to come up faster.”*
- *“Compensation plans are complicated. If you try to reduce it down to letting a group of shareholders who don’t have access to data or people [make decisions,] you’re going to have bad decisions made. It’s hard enough for us – meeting six times a year – to come to these decisions. All of it troubles me from a governance standpoint.”*
- *“At some level we have to think about which issues are real and which issues are not. I think that say-on-pay probably falls somewhere in the middle. We’re not going to be able to win it – it’s an absolutely unwinnable issue ... We [expended resources to oppose say-on-pay] because if you don’t show you’re willing to fight, there’s going to be something else, then something else, then something else.”*

Bailout bill provisions

On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act into law. What is commonly referred to as the bailout bill gives the Treasury Department the power to buy distressed assets from banks and other financial firms.⁴ One component of the act, the Troubled Assets Relief Program (TARP), includes several substantive requirements related to executive compensation.

Specifically, compensation committees in those companies participating in TARP “are required to certify in their CD&As that they have taken measures to ensure that executive incentive compensation policies have not encouraged and do not encourage ‘unnecessary and excessive risks that threaten the value of the financial institution by the executive officers.’”⁵

Most recently, on February 4, 2009, President Obama announced a salary cap of \$500,000 for top executives at companies that receive the largest amounts of bailout money going forward, calling the step an expression not only of fairness but of “basic common sense.”⁶ In addition to the \$500,000 salary cap on cash compensation, the new rules also would “curtail severance pay when top executives [leave] a company, restrict cashing in on stock incentives until government assistance [is] repaid and prod corporate boards to closely scrutinize luxury perquisites.”⁷

⁴ “Emergency Economic Stabilization Act of 2008,” Section 111(b)(2)(A).

⁵ “SEC Division Director White Draws CD&A Lessons from TARP and 2008 Filings,” *Corporate and Financial Weekly Digest* (KattenMuchinRosenman), October 31, 2008, 1. Available online at http://www.kattenlaw.com/files/Publication/a31c6c11-43f1-4e9b-9dec-0228dc56f187/Presentation/PublicationAttachment/5e688b3a-73b6-48b0-9dae-04f8455b4cb6/Corporate_and_Financial_Weekly_Digest-10_31_08.pdf.

⁶ Edmund L. Andrews, Vikas Bajaj, and Brian Knowlton, “Obama Imposes Salary Cap for Firms That Join Bailout,” *International Herald Tribune*, February 4, 2009. Available at <http://www.iht.com/articles/2009/02/04/america/prexy.4-423182.php>.

⁷ Stephen Labaton and Vikas Bajaj, “In Curbing Pay, Obama Seeks to Alter Corporate Culture,” *New York Times*, February 4, 2009. Available at <http://www.nytimes.com/2009/02/05/us/politics/05pay.html?ref=economy>.

For their part, many CCLN members don't see the government enforcing executive pay restrictions beyond TARP: *"I don't really believe the government has any desire to come and sit down in meetings and make rulings on this. They are counting on the fact that if they put in restrictions, people will say, 'Damn right, about time!' and consequently companies will be more careful about setting targets and pay. I really don't see this as a true desire by the government to get into the office of management on corporate salary."*

Although many members admit they *"are still trying to figure out what it all means,"* several also say that regardless of the ultimate outcome, the increased scrutiny the legislation has brought on executive pay creates an opportunity for compensation committees: *"I think all of this is going to give us the authority to do what we were meant to do [as compensation committees]: to push back on management and design effective pay [plans]. I think these are all positive developments, and I think [they are] going to drive us to an area where we're going to do our job better."*

Designing compensation plans in 2009

Prior to the February meeting, members remarked on the historic significance of setting executive compensation in 2009. Said one: *"I have been around these issues [for several decades], and I can't remember when there wasn't an outcry that CEOs were making too much money. The issues have always been here, but they have never really driven change. However, this financial crisis, combined with the public outcry, makes me think [we] may finally ... see some fundamental change in executive compensation design."*

At the meeting, members discussed several key areas of compensation plan design they are assessing this year.

Long-term incentive plans: addressing underwater options

Members report that long-term incentive plans have become *"the Wild, Wild West"* as companies struggle to assess the longer-term implications of the economic crisis on executive pay. As of October 17, 2008, a staggering 90 percent of *Fortune* 500 CEOs held underwater stock options, up significantly from 2007, when 61 percent held underwater options.⁸ And with stock prices on average down 45 percent since last October, and many companies' stock prices down as much as 80 percent, it is no surprise that underwater stock options are the norm for most leading companies.⁹

Many companies have made the move to restricted-stock performance-based long-term incentive plans over the last few years.¹⁰ The goal of these plans is to align executives' interests with those of shareholders, and they often reduce share dilution significantly by providing the same value as options with fewer shares. In fact recently we have seen a shift to an equity-portfolio approach, including time-restricted stock units, performance-restricted stock, and performance-share units.

⁸ "CEOs Awash in Worthless Options," *Directorship*, October 31, 2008. Available at <http://www.directorship.com/underwater-stock-options>.

⁹ DolmatConnell & Partners, "Executive Compensation in a Troubled Economy: Different Thinking for Different Times" (white paper, November 2008). Available online at <http://www.dolmatconnell.com/site/Portals/0/Documents/ExecCompTroubledEconomyWhitepaper.pdf>.

¹⁰ *Ibid.*

A number of members argue that fluctuations in the economy should not impact the design of compensation plans. Said one: *“When it comes to designing compensation, it’s like a recipe – mix of balancing short- and long-term compensation, and if you get it right, stick with it. Don’t mess with it just because we’re in a downturn. It’s meant to have pieces of pay that are shorter term and longer term in nature. Leave it alone.”* Added another member who favors sticking with a current plan: *“I believe options with strong retention requirements are the best approach. We rarely do restricted stock. I still really like options as the best way to tie executives to shareholders. It does bring about problems when they’re underwater though.”*

Still, several members at the meeting insisted that the challenges presented by the current environment make changes to equity compensation necessary. In particular they are considering the following:

- **Special grants.** Some members would leave existing options but also would consider issuing new options or accelerating vesting and expensing of underwater options. *“We’re looking at issuing a supplemental grant with unusual terms to make up for some of the lost value. If this is just short term and the world returns to where it was, we don’t get a double dip. This creates a mechanism that tries to make up some of what’s been lost.”* Although this alternative addresses motivation and retention concerns, members acknowledge that it also can contribute to dilution of the option pool.
- **Option exchange.** For many, *“re-pricing is a bad word;”* but a number of participants at the February meeting acknowledged that they are coming around to the idea: *“I think that re-pricing may actually be the shareholder-friendly thing to do and the least expensive way of locking in talent. We haven’t made our commitment yet, but I’m seriously looking into it. I was in the ‘no way’ camp ... but I’m becoming convinced that it might be the right thing to do.”* And several members are considering an exchange program whereby employees would be offered new stock options in exchange for canceling underwater stock options. Under this plan, the company would determine the value of the underwater option and use that value as a basis for determining the exchange level for cash, new options, or full-value shares: *“We’re considering an exchange program. It’s a motivational issue because stock is down [significantly]. It’s a simple one-for-one exchange.”* Said another member: *“We’re going to give an exchange and issue new options that are equal to or less than those options.”* But a third member cautioned: *“I think you have to tread lightly on any exchange or re-pricing ... As soon as you say ‘make up for lost value’ to shareholders, oftentimes the proposal is dead on the table.”*
- **More restricted stock.** *“We’ve evolved the max over time from what were all options to option-restricted stock. Now chief executives receive half options and half performance shares. I think we’re feeling pretty good about it.”* One member remarked prior to the meeting: *“We need to make sure we hold on to these people, and you do that with restricted stock.”*

Members acknowledge that this is not an exhaustive list of possible changes to equity compensation. Other considerations include canceling underwater options altogether or extending option expiration dates.

Still, the debate among members around the value of options continues: *“The problem I see with options as they are is they have a lot of ‘rising tide’ elements. That’s the main issue.”* And another member pointed out that when it comes to options, *“a lot of it is the timing and whether you give options today versus when the market is good.”* Several members feel options continue to be a popular

equity vehicle when executives are given the choice. One noted that “80 percent of executives took options last year, and 84 percent took options this year.” Ultimately most agreed with the member who said, “Options can be good. But if at the end of the day you don’t think there’s any value in issuing options, don’t issue them.”

Setting targets despite “poor line of sight”

Members agree that volatility in the markets and the difficulty of predicting political responses to that volatility are causing them to re-assess the way they set compensation targets for 2009:

- **Re-evaluate the plan after six months.** “We decided we would do a review after six months and see what the world looks like. It’s a yearlong program – we’re looking at operating income and cash. Cut that in half and take a piece of it and put it toward a specific target. We will look in six months and see where we are. If people can’t do anything midyear, you might lose some of the momentum you’re trying to build.”
- **Pay out a one-year plan after six months.** “We actually have designed a full-year plan, but we are paying out at six months as well as at the end of the year. We did this for two reasons: First, we didn’t want people to do extremely well in the first half and then do stupid things in the back half. This provides a closer line of sight. And second, we wanted to help employee welfare. People appreciate the fact that we will pay out sooner.”
- **Change the mix of targets.** “We split the incentive plan into two pieces: net income and operating targets. We don’t know how the plan will work out, so we’ve set up operating targets and we’ll measure them quarterly and draw them in pieces ... to avoid what happened this year when the whole fourth quarter fell out.”
- **Move to a six-month plan.** “We are doing an actual two-step six-month plan. We haven’t even talked about what the targets will be in June. We have no visibility, no runway. It will be a little more work [for the compensation committee], but I think it will be worth it.”

Members agree that despite poor visibility, compensation committees should not view the interests of shareholders and employees as mutually exclusive. Many CCLN members report that they will continue to reassess and reengineer their compensation targets for 2009 in an effort to strike a balance that works for everyone.

Reassessing peer groups

CCLN members intend to re-examine peer-group comparisons as they re-evaluate compensation plan design in 2009:

- “We have a peer group, but we’re trying to bring in a [broader list] and say, ‘I know we’re up here [in the higher range of performers], but this is where most of America pays CEOs and everyone else.’ We have to start moving more into a range that doesn’t just look at [our specific industry]. We’re trying to put another lens or filter on what we really pay and whether it makes sense or not. Do we really need to pay a target of \$12 million when other similarly sized companies are paying \$5 million to \$8 million? I’m looking at this particularly for the new people coming in.”

- *“We view peer-group comparisons in three slices: industry peer group (11 to 12 companies), sample of general industrial companies with similar behaviors (about 25 companies), and then take a survey of much broader companies.”*
- *“There’s at least one group of businesses that has completely abandoned [its] peer group in favor of another peer group, and that’s investment banks. They’re now looking at commercial banks. I think right now we’re not seeing anything play out because the acquirers are saying they have no place to go. I think the proof in the pudding will come either when deals are up or when things start to get better.”*

Taking another look at severance agreements

Severance packages are also undergoing reassessment. Said one member: *“I think the whole severance model is set up to embarrass us as compensation committees. I know that in the case of a lot of the recent terminations, boards have said they’re not going to pay. I think that’s an area I would like to look at this year. I think it’s ripe for change.”*

Indeed members agree that compensation committee chairs should feel comfortable putting their foot down when it comes to making changes to the severance model: *“I think when someone’s been in place for X amount of time, the compensation committee has to feel comfortable saying, ‘When severance comes up, we’re going to have to assess the [current economic] times and make a decision then.’”*

Despite agreement that there’s room for change around severance arrangements, most members report they are still interested in keeping current change-in-control provisions: *“As you get into change-in-control agreements things change. You start to see double triggers. Three areas you have to focus on when assessing change-in-control agreements are (1) how many participants, (2) what are the right severance multiples, and (3) what are you going to do on the gross up ... You can’t educate people enough around the issue. If you’re on a committee and haven’t reviewed the plan, you need to review it.”*

Private versus public company approaches

In previous meetings, CCLN members had commented that there may be some value in comparing the approaches that private-equity firms take when selecting, developing, and rewarding top executives to the approaches taken by large public companies. So we were delighted that Michael Chae, senior managing director at The Blackstone Group, was able to join our discussion on February 5.

In the discussion, members identified several significant differences between public and private companies:

- **The way private companies set pay.** Private-equity companies clearly enjoy a competitive advantage because of their ability to set pay levels without the added concern for what shareholders think or what the implications will be on pay equity.
- **How and what executives at private companies get paid.** Members discussed the fact that from a wealth-building standpoint, executives of private companies might be looking at making three to five times what they would be making in the public sector. However, often the big payday doesn’t come for a number of years, and compensation in the interim isn’t liquid.

Mr. Chae acknowledged that although *“it doesn’t work all the time, when it does work, it works well.”*

- **Management development.** *“Private-equity firms want a proven performer who can hit the ground running as well as bring in previous relationships. If it takes 25 percent to pry them out, they’re not afraid to do that. They are much more focused on the right person now. Public companies look more at structure and fit.”* Added Mr. Chae: *“Typically when we change a CEO, we’ve already been looking for a new one. We’ll use both formal and informal relationships. Oftentimes we’ll look outside the company.”*
- **Fundamental governance structure.** *“Management teams at public companies are not used to being asked the tough questions by the board. A lot of private-equity directors view themselves as pseudo-CEOs. They aren’t as nice with their questions, and they aren’t as forgiving when last month’s promises don’t match up with this month’s results.”* Pointed out another member: *“Sounds like the board of a private company is more like another layer of management.”*

By the conclusion of our discussion, members ultimately came away with several practices that could be employed by their boards:

- **Value of spending more time on the issues.** *“The character of board meetings is different [in private companies]. They are much longer, and they cover a lot more.”* One member considers longer meetings time well spent: *“When we finish a public company board meeting, we always seem to leave something to be done. On private company boards, it’s not, ‘When can you fit it in?’ It’s their job, and they make it happen. I think we would be more effective as boards if we were able to devote that kind of additional time.”*
- **Value of focusing on strategy versus compliance.** *“Private companies enjoy the luxury of spending much less time on compliance issues and much more on the strategic issues.”* Although compliance clearly will continue to be a significant element of public company directors’ responsibilities, members agree that they could and should carve out more time to focus on longer-term, strategic issues.
- **Thinking about compensation as a percentage of profit.** *“Private companies are very focused on calculation of the incremental profit and how much of that is going toward the management team. They look at how much value was created, and they are focused on the EBITDA.”* Added another member: *“I like the idea of viewing executive compensation as a percentage of profit. It’s clean, and it’s simple. I think we’ve lost that, and I’d like to get back to it.”* Of course, members acknowledge that as company size increases, compensation as a percentage of profit becomes a less realistic approach to designing compensation. But a number of members professed interest in using the logic of percentage of profit compensation as a test on their current systems.
- **Value of staff support.** *“It’s a private-equity director’s full-time job to be on boards, but I get my board book on Saturday before the meeting, and I’m still reading right up until the meeting starts. If I had a staff [like the private-equity firms have], then things would be different.”* Echoed another member: *“Staff is a very big component. Your capacity [as a director of a public company] to do any form of independent analysis is whatever you can do on your own.”*

Joint considerations for audit and compensation committees

Select members of the Audit Committee Leadership Network joined the CCLN members to discuss issues that pertain to both audit and compensation committees in U.S. public companies. The following ACLN members took part in the meeting:¹¹

- Steve Almassy, Americas Assurance Leader, Ernst & Young
- Eugene V. Fife, Audit Chair, Caterpillar
- Steve Howe, Americas Managing Partner, Ernst & Young
- Marie L. Knowles, Audit Chair, McKesson
- Oscar Munoz, Audit Chair, Continental Airlines
- Charles A. Noski, Audit Chair, Microsoft and Morgan Stanley
- Steven M. West, Audit Chair, Cisco Systems
- Peter V. Ueberroth, Audit Chair, The Coca-Cola Company

ACLN and CCLN members identified a number of areas where their responsibilities intersect. Specifically, they identified three areas in which board performance could be improved through greater collaboration between audit and compensation committees and their chairs:

- Addressing underwater stock options
- Setting performance targets and determining quality of earnings
- Finding ways to engage the full board and each committee

Addressing underwater stock options

Most executives hold stock options that are now deeply underwater. There is little hope that these options will rebound to their strike price over the next several years. That means these options are unlikely to fulfill their purpose – to motivate, retain, and reward the company’s leaders. Yet FASB Statement 123(R) requires that companies continue to record expenses for these options. The result: options that yield expense without benefit. That leaves directors to ask: *“How do you maintain the motivation and attention of top people in this environment ... and do it in a way that is shareholder-friendly?”*

Audit committee chairs are quick to point out that *“accounting rules circumscribe”* the range of possible approaches to underwater options. The alternatives are further constrained by stock exchange listing requirements, the need for shareholder approval, and employee eligibility. And, of course, dilution is always a primary concern for all board members. As one director said, *“At current stock prices, if we target a particular compensation value and work back to an option grant, then we will burn through a lot of the available options.”*

Audit and compensation committee chairs agree that close collaboration and full board involvement are crucial to protect the interests of shareholders and deliver wanted compensation outcomes. One

¹¹ The audit committee chairs are identified by their qualifying board memberships. Steve Almassy and Steve Howe participated in their capacity as accounting experts and sponsors of the ACLN. For more information on the ACLN, please visit http://www.tapestrynetworks.com/networks/net_north_america.html.

director suggested that the full board consider three questions before taking action on underwater options:

- **“Do we have a problem to solve?”** While performance and retention considerations may lead the board to modify stock option plans, *“it may be appropriate to stick with the plan and tell management, ‘When the share price falls, you lose money. Just like the shareholders.’”*
- **“Do we really have a retention issue?”** As one participant concluded, *“Retention can be illusory ... Voluntary churn rates are at their lowest levels in years. Do we really think we are going to lose key performers?”*
- **“Are we willing to send the message that we don’t expect the stock price to recover?”** If the drop in share price is seen as temporary or otherwise recoverable, then it may be most appropriate to take no action on underwater options. Canceling or exchanging options could *“send the wrong message”* to the market about the underlying value of the company.

Setting performance targets and determining quality of earnings

Current market conditions are making it exceedingly difficult for boards to set relevant performance goals and targets for 2009.¹² While many compensation committees will be assessing their targets more frequently, audit committee chairs will continue to focus on whether the metrics used to assess performance are appropriate and accurate. Once the metrics (e.g., sales growth, operating income, EPS – sometimes relative to other companies in the industry to deal with the down economy) are established and the absolute targets set by the full board, audit and compensation committees both have a role in determining the quality of the data used to assess success against these quantitative measures. One audit committee chair asked of the compensation committee chairs: *“How do you know you have the right data? ... It is too easy to game.”*

Meeting participants acknowledged that there are *“inherent judgments in interpreting accounting results”* and that these judgments are key determinants of incentive compensation. They observe that *“there is not a lot of dialogue”* among directors about this despite *“a strong sense that there should be.”* One director characterized the situation as a *“compartmentalization of the board”* in which *“the audit committee doesn’t participate in defining the metrics or the size of the incentive plan”* and the compensation committee may not *“get behind the numbers and understand the performance behind those numbers.”*

Audit and compensation committee chairs agree on the importance of increased *“quality-of-earnings dialogue”* to correct this potential compartmentalization of responsibility and *“ensure the compensation system does not encourage excessive risk.”* One audit committee chair said that if audit committee members sit in on compensation committee meetings, they can understand how the metrics are set and can then see *“if the numbers are being pushed one way or another”* by management, increasing their ability to identify risk.

One member suggested that any adjustments made to accounting results for compensation purposes be reviewed with the full audit committee. A compensation committee chair said, *“If we make a strategic decision to shut down a line, or there were significant interest rate fluctuations in the period, it may make sense to make an adjustment. We don’t do that without reviewing the decision with the audit*

¹² See page 8 for further discussion of performance target reviews and their frequency.

committee.” In so doing, directors felt they could ensure that “*when the comp committee looks at the numbers, they are looking at what they think they are looking at.*”

Members acknowledge management’s sensitivity to these conversations. “*I am not sure I like the idea of setting the compensation plan and then, if management delivers, saying that the ‘quality’ wasn’t quite what we wanted. I think we have to be very careful with that.*” One director proposed that the audit and compensation committee chairs work together to bring management directly into the process. “*The audit committee can request that management present the numbers a certain way and asks the auditor to confirm those numbers. That information would then be shared with the compensation committee. Management is aware of this and can be a part of the discussion.*” Another audit committee chair added: “*The audit committee or the external auditor needs to make sure the data feeds are really what they should be.*”

Finding ways to engage the full board and each committee

“All board members evidence interest in understanding how executive compensation works – the measures, the targets, how they were set and how the committee decided on the formula that would be used ... The board wants to understand this. It is not just comp and audit.” Participants agreed that full understanding of the compensation plan and the company financials are core responsibilities of all directors: “*You want the directors to be able to confidently say yes to two questions: ‘Do you really understand the compensation program?’ and ‘Do you really understand the financials?’*”

Recognizing certain basic responsibilities for all directors, one director commented that compensation and audit committee chairs may be uniquely positioned to oversee and support the development of full-board understanding in these areas: “*The board has to fight compartmentalization.*” Participants identified some specific ways to do that, including the following:

- **Greater communication between committee chairs.** Participants pointed out that direct interaction between the committee chairs helps ensure the quality and accuracy of the financial data used to determine compensation plan payouts. In response to the question “What will you do differently as a result of this ACLN–CCLN meeting?” one compensation committee chair said, “*Talk to my audit chair more!*”
- **Executive sessions before board meetings.** Members described the increasing importance of executive sessions, particularly when sensitive compensation issues are under discussion, and the need for each director to bring his or her full focus to these sessions. One compensation chair noted: “*Our last executive session was all about comp ... It is not unusual for the comp committee to have a particular point of view and hear the reactions of others and make a change.*” Another said, “*The full board has to get hungry to know how the system works. Targets don’t get the extra scrutiny. We take them for read if the company says they’re OK.*” Yet “*executive sessions can be rushed, especially if they are scheduled at the end of the board meeting. People are trying to make planes, have to leave, etc.*” An effective solution, in many cases, may be to schedule an executive session before the start of the full board meeting or at a time other than the end of the meeting.
- **Cross-committee membership.** Members see value in having at least one director serve on both audit and compensation committees. This helps each committee know “*what questions to ask*” and helps members of each committee answer the question “*What am I not asking that I should be?*”

- **Special education sessions for non–compensation committee board members.** One audit committee chair described how management and the compensation committee held a tutorial customized for each individual board member to explain how people in the company were paid.

An audit committee chair set out the goal for greater collaboration: *“Some level of accountability and rewards aligned with what’s delivered. Expectations set clearly, not in a backroom. We all represent shareholders, and we should ask, ‘If I was a shareholder, what would I think?’ I have to keep asking the questions until I understand it.”*

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