

Joint considerations for audit and compensation committees

Introduction

On February 5, 2009, members of the Audit Committee Leadership Network (ACLN) met in New York for the network's 19th stand-alone meeting. Members discussed funding and liquidity issues in today's capital markets.¹ Members also discussed the audit committee role in financial communication.² ACLN members then joined Compensation Committee Leadership Network (CCLN) members to discuss issues that pertain to both audit and compensation committees. This *ViewPoints* contains a synthesis drawn from the joint session.³ For further information about the ACLN, see "About this document," on page 7.

ACLN and CCLN members 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 both committees**

The following members of both networks, who sit on the boards of nearly 30 large-, mid-, and small-cap public companies between them, took part in all or part of the joint session:

Audit Committee Leadership Network	Compensation Committee Leadership Network
Steve Almassy, Americas Assurance Leader, Ernst & Young	Dina Dublon, Compensation Chair, Microsoft
Gene Fife, Audit Chair, Caterpillar	Stephen Kaufman, Compensation Chair, Harris Corporation and Thermo Fisher Scientific
Steve Howe, Americas Managing Partner, Ernst & Young	Peter Miterko, Hewitt Associates
Marie Knowles, Audit Chair, McKesson	Michael Powers, Hewitt Associates
Oscar Munoz, Audit Chair, Continental Airlines	Wim Roelandts, Compensation Chair, Applied Materials
Chuck Noski, Audit Chair, Microsoft and Morgan Stanley	Steve Sanger, Compensation Chair, Wells Fargo
Steve West, Audit Chair, Cisco Systems	Dan Schulman, Compensation Chair, Symantec
Peter Ueberroth, Audit Chair, The Coca-Cola Company	Laurie Siegel, Compensation Chair, Embarq

¹ See Audit Committee Leadership Network, "Funding and liquidity in today's capital markets," *ViewPoints*, March 5, 2009. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Mar09_View24.pdf

² See Audit Committee Leadership Network, "Financial communication and the audit committee," *ViewPoints*, March 5, 2009. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Mar09_View25.pdf

³ For more information on the CCLN, please visit http://www.tapestrynetworks.com/networks/net_compensation.html. For the full synthesis of the CCLN meeting, see Compensation Committee Leadership Network, "The economic and financial crisis: implications for the compensation committee," *ViewPoints*, February 5, 2009. Available at http://www.tapestrynetworks.com/documents/Tapestry_CCLN_View_Feb09.pdf

ViewPoints reflects both networks' 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. Quotations in italics are drawn directly from members of both networks.

Executive summary

Members of both the ACLN and CCLN recognize that there are a number of areas in which greater collaboration between the audit and compensation committees can improve board performance. During the joint session, they discussed three of those areas, which are covered in more detail on the following pages:

- **Addressing underwater stock options** (*Page 3*)

Compensation chairs described the dilemma they face concerning executive stock options that are currently underwater and unlikely to fulfill their purpose of motivating, retaining, and rewarding the company's leaders. Audit chairs pointed out that possible approaches to dealing with underwater options are often circumscribed by accounting rules. Chairs of both committees agreed that close collaboration and full board involvement are crucial to protect the interests of shareholders.

- **Setting performance targets and determining quality of earnings** (*Page 4*)

While many compensation committees are assessing performance targets more frequently in the current economy, audit chairs focus on whether the metrics used to assess performance are appropriate and accurate. Despite the fact that judgment is a key determinant of incentive compensation, there is a lack of dialogue among boards, which are often compartmentalized. Chairs of both committees agreed on the importance of an increased "*quality-of-earnings dialogue*" to correct this potential compartmentalization of responsibility and avoid excessive risk taking by management.

- **Finding ways to engage the full board and both committees** (*Page 5*)

Participants agreed that compensation and audit chairs may be uniquely positioned to help the full board understand both the compensation plan and the company financials. Participants see value in direct interaction between the committee chairs, and they believe that executive sessions of the board are valuable opportunities to discuss sensitive compensation issues. Participants also noted that it can be beneficial to have at least one director serve on both the audit and compensation committees and supported in-depth education sessions for non-compensation committee board members on how management is paid. For questions for audit committees to consider on compensation issues, see the appendix on page 8.

Addressing underwater stock options

Most executives hold stock options that are now deeply underwater. As of October 17, 2008, a staggering 90% of *Fortune* 500 CEOs held underwater stock options, up significantly since 2007, when 61% held underwater options.⁴ Indeed, with stock prices on average down 45% since last October and many companies' stock prices down as much as 80%; it is no surprise that underwater stock options are the norm for most leading companies.⁵

Many audit and compensation chairs believe 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 No. 123R, Accounting for Stock-Based Compensation, requires that companies continue to record expenses for these options.⁶ The result is options that yield expense without benefit. As a participant said, that leaves directors to ask, *"How do you maintain the motivation and attention of top people in this environment ... in a way that is shareholder-friendly?"* Although the discussion focused on executive compensation, network members have expressed similar concerns about other highly paid employees.

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 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.

⁴ "CEOs Awash in Worthless Options," *Directorship*, October 31, 2008. Available at <http://www.directorship.com/underwater-stock-options>.

⁵ DolmatConnell & Partners, *Executive Compensation in a Troubled Economy: Different Thinking for Different Times* (Waltham, MA: DolmatConnell & Partners, 2008). Available at <http://www.dolmatconnell.com/documents/file/ExecComp%20Troubled%20Economy%20Whitepaper.pdf>.

⁶ A summary of the FASB statement is available at <http://www.fasb.org/st/summary/stsum123r.shtml>.

Setting performance targets and determining quality of earnings

A reliable assessment of quality of earnings continues to elude investors. “Earnings quality refers to the ability of reported earnings to reflect the company’s true earnings, as well as the usefulness of reported earnings to predict future earnings. Earnings quality also refers to the stability, persistence, and lack of variability in reported earnings.”⁷

Current market conditions are making it exceedingly difficult for boards to set relevant performance goals and targets for 2009.⁸ 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, earnings per share) 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 observed 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 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 participant suggested that any adjustments made to accounting results for compensation purposes be reviewed by the full audit committee. A compensation committee chair said, *“If we make a strategic decision to shut down a [product] 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 committee.”* This practice aims to ensure that *“when the comp committee looks at the numbers, they are looking at what they think they are looking at.”*

Members acknowledge the difficulty of 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 ask the auditor to confirm those numbers.”*

⁷ Jodi L. Bellovary, Don E. Giacomino, and Michael D. Akers, “Earnings Quality: It’s Time to Measure and Report,” *CPA Journal*, November 2005. Available at <http://www.nysscpa.org/cpajournal/2005/1105/essentials/p32.htm>.

⁸ Compensation Committee Leadership Network, “The economic and financial crisis: implications for the compensation committee,” 8.

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.”

The intersection of risk and reward

- U.S. and European regulators, as well as members of U.S. and European audit committee networks, have acknowledged that executive pay, because of its role in increasing executives’ appetite for risk, has been one of the drivers of the financial crisis.⁹ One compensation chair stated before the joint session, *“If this crisis has taught us anything, it’s that there was an awful lot of lip service paid to risk assessment, but the kind of rigorous, disciplined work that needed to be done was not done in a lot of cases.”*
- Audit and compensation committees recognize that risks taken by management to achieve goals are *“apparent long after the rewards are booked.”* The challenge now is to understand how to adjust compensation programs both to eliminate this imbalance and to ensure greater rigor in identifying risks.
- Although audit committee chairs voice reservations about playing a role in the pay-setting process, one subject matter expert insisted that *“audit committees should understand clearly how executives are paid and the key drivers of the overall remuneration programme so that they can evaluate the potential effect on the company’s overall risk profile.”*¹⁰
- Some audit committee chairs have suggested provisions in compensation packages that would allow companies to reclaim compensation or rewards in cases of subsequent poor performance, as well as the use of risk-adjusted pay for performance, so that senior executives’ pay would reflect the amount of risk taken in reaching performance targets.

Finding ways to engage the full board and both committees

Participants agreed that all directors should have a full understanding of the compensation plan and the company financials: *“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?’”*

Another participant commented, *“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.”* One director noted that compensation and audit committee chairs may be uniquely positioned to oversee and

⁹ Senior Supervisors Group, *Observations on Risk Management Practices During Recent Market Turbulence* (Basel, Switzerland: Financial Stability Forum, 2008), 7. Available at http://www.newyorkfed.org/newsevents/news/banking/2008/ssg_risk_mgt_doc_final.pdf.

¹⁰ European Audit Committee Leadership Network, “An Increased Role for Audit Committees in Remuneration,” *InSights*, June 27, 2008, 7. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_InSights_Jul08.pdf.

support the development of full board understanding in these areas, and added, “*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.** Participants described the increasing importance of executive sessions, particularly when sensitive compensation issues are under discussion. 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 as 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.*” 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.

Other ideas for improving communication between audit and comp committees¹¹

- **Joint meetings.** Some audit and compensation committees schedule joint meetings periodically to discuss specific issues.
- **More comprehensive information.** Some companies share all committee reports with every director to be sure the entire board is fully briefed on key issues.
- **Open invitations.** Some companies have an open invitation for board directors to sit in on committee meetings other than their own, if they have time.
- **CEO advisory committee.** Some companies have instituted a CEO advisory committee composed of the audit, compensation, and governance committee chairs as a coordination mechanism.

¹¹ Based on Ernst & Young and Tapestry Networks, “Improving communication between audit and comp committees,” *InSights*, December 22, 2006, 7. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Dec06_InSights_13.pdf.

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 back room. 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.”*

Conclusion

At their February meeting, CCLN members acknowledged that the events of 2008 left them struggling to navigate *“uncharted waters”* as they worked to oversee compensation in an extraordinary period of change, bracing for outspoken criticism of executive pay packages, and anticipating sweeping legislative and regulatory reform. Compensation chairs anticipate that 2009 will be equally eventful; they will be looking to the audit chair as an ally in the struggle against compartmentalization of the board and the effort to link the oversight of risk and reward throughout their companies.

For audit chairs, working more closely with the compensation committee can help to reduce both the fraud risk that increases in a troubled economy and the reputation risk associated with executive pay. The CEO’s compensation was identified as a potential reputation risk in the network’s very first in-person meeting in 2003. At that time, *ViewPoints* reported that members were of the opinion that *“the audit committee should be explicit about its role and responsibility for helping to set the tone at the top of the corporation.”*¹²

About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The views expressed in this document represent those of the Compensation Committee Leadership Network and the Audit Committee Leadership Network. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the US member firm of Ernst & Young LLP.

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¹² Audit Committee Leadership Network, “Audit committee emerging roles and responsibilities,” *ViewPoints*, October 15, 2003, 3. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Oct03_View2.pdf.

Appendix: Questions for audit committees to consider on compensation issues

- ? How comfortable are you with your level of understanding of the risks associated with your company's compensation and reward systems? What messages does your compensation plan send to management about the appropriate level of risk-taking behaviors? How effective is your company at addressing the link between risk and compensation?
- ? From whom do you derive your insight on these risks? How reliable are these sources of information? What additional information would you like to be receiving?
- ? How does your board review and approve your company's pay philosophy? Are you comfortable with this process? Is there adequate discussion regarding the impact on your company's risk profile? Do you feel this will change as a result of the financial crisis?
- ? What is the degree of discussion on your board concerning the relevance of performance targets? Would you like to see that change? If so, how?
- ? What role does the audit or compensation committee play in revising performance targets?
- ? What is best practice when it comes to the audit committee's review of the financial data that the compensation committee uses to determine compensation payouts? What triggers should the audit and compensation committees be aware of that could lead management to manipulate these data?
- ? What process is in place to ensure that all compensation-related plans are reviewed by the accounting department so that the plans can be appropriately accounted for in the financial statements?
- ? How should external advisers to the audit and compensation committees work together? How do these committees address independence issues associated with the involvement of external advisers?
- ? What degree of interaction do you think is needed between the audit committee and the compensation committee? Are there a sufficient number of joint meetings and/or committee overlap to ensure communication on key topics?
- ? What would you most like to see change in terms of your board's oversight of compensation programs? Do your fellow directors agree?