

## Improving communication between audit and compensation committees

### Introduction

In the past, board committee responsibilities rarely intersected, and there was little need for committees to share information outside of their reports to the full board. However, with audit and now compensation committees subjected to increased media, investor, and regulatory scrutiny, many directors see an evolving interrelationship. Issues such as stock option backdating and the new compensation discussion and analysis (CD&A) disclosures are positioned at the intersection of the two committees' oversight responsibilities, and they raise new questions for boards and management.

In order to better understand the developing relationship between these key board committees, Tapestry Networks spoke with a dozen board directors, all of whom serve on both audit and compensation committees (though not necessarily at the same company).

All participants are members of networks of board committee chairs orchestrated by Tapestry Networks. Audit committee networks are convened by Ernst & Young. Mercer Human Resource Consulting sponsors and supports the Compensation Committee Leadership Network. Participants in the research included:

- Eddie Adair, Southeast Audit Committee Network
- John Dillon, Compensation Committee Leadership Network
- Gordon Harnett, North Central Audit Committee Network
- Sherrill Hudson, Southeast Audit Committee Network
- Bill Lawrence, North Central Audit Committee Network
- Mike Losh, North Central Audit Committee Network
- Vic Pelson, Compensation Committee Leadership Network
- Paula Rosput Reynolds, Pacific Southwest Audit Committee Network
- Paul Smith, North Central Audit Committee Network
- Bill Smithburg, North Central Audit Committee Network
- Peter Ueberroth, Audit Committee Leadership Network
- Sandy Warner, Audit Committee Leadership Network

Each participant chairs at least one of the board committees, and 8 of the participants have served as either CEO or CFO of a publicly traded company. Collectively, participants serve on 28 board audit committees (18 as chair), and 22 board compensation committees (7 as chair). [Current board committee affiliations for each participant are included in Appendix A on page 9.](#)

This document uses a modified version of the Chatham House Rule whereby names of contributors to the research and their company or organization affiliations are a matter of public record, but the comments made in the conduct of the research are not attributed to individuals.

## Executive summary

Participants generally agreed that boards and audit committees will need to become more engaged in the work of the compensation committee and that the board should ensure that processes are in place to foster good relations and effective communication between the two committees. Participants made several important observations, which are expanded upon in the following pages:

- **New compensation disclosures may affect board and auditor roles and relationships** (Page 2)

Like the audit committee, the compensation committee is now in the spotlight. Companies will be filing new compensation disclosures for the first time in early 2007, and directors are coming to terms with the significance of the new regulations. Some directors worry that unclear or insufficient regulatory guidance may result in lengthy, complex disclosures.

In order to satisfy their oversight responsibilities, many boards will ask audit committees to review the compensation disclosures. Additionally, internal or external auditors may be asked to provide an independent review of compensation controls and disclosures. Several participants predict that these new requirements will lead to new relationships between internal and external audit and the compensation committee.

- **Effective board and committee coordination is difficult but necessary** (Page 5)

Audit and compensation committee responsibilities have always cooperated to some extent, whether in discussing proper consideration of extraordinary events, ensuring the effectiveness of controls, or assessing the magnitude, timing, and implications of incentive compensation. While the committee model allows boards to carry out their oversight responsibilities efficiently, time constraints and ineffective communication channels may impede deliberative discussions. As committee responsibilities start to intersect more frequently, the board as a whole is taking up discussion of complex issues to ensure their adequate consideration.

- **Some companies are adopting new mechanisms to coordinate committee activities** (Page 7)

At the most basic level, committee coordination always occurs during board meetings. However, there may be additional value in developing more purposeful mechanisms outside of formal board meetings, including joint meetings, committee cross-membership, more comprehensive sharing of presentations, and formal or informal discussions between committee chairs.

## New compensation disclosures may affect board and auditor roles and relationships

Audit committee members, who have felt under a spotlight in recent years, can surely sympathize with the scrutiny their colleagues on the compensation committee are now receiving. A recent *Compliance Week* article noted, “Just as the Sarbanes-Oxley Act boosted the profile – and workload – of audit-committee members four years ago, observers say compensation committee members will find themselves increasingly under a similar microscope.”<sup>1</sup> A participant agreed: “*This furor over executive comp will not go away.*”

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<sup>1</sup> Melissa Klein Aguilar, “Compensation Committees In Line Of Fire,” *Compliance Week*, November 28, 2006. Available to subscribers at [http://www.complianceweek.com/index.cfm?fuseaction=article.SavedSearchResults&search\\_ID=51](http://www.complianceweek.com/index.cfm?fuseaction=article.SavedSearchResults&search_ID=51).

From the audit committee's perspective, the most notable development is a new regulatory requirement to expand executive compensation disclosure.

### **Compensation Discussion and Analysis (CD&A)**

On July 26, 2006 the Securities and Exchange Commission (SEC) voted to require more extensive disclosure of executive and director compensation. The amendments to the rules are intended "to refine the tabular disclosure and combine it with improved narrative disclosure to elicit clearer and more complete disclosure of compensation of the principal executive officer, principal financial officer, the three other highest paid executive officers and the directors."<sup>2</sup>

Public companies with a fiscal year ending after December 15, 2006 are required to include the CD&A disclosure as part of the compensation committee report in their next annual proxy. The CD&A will be "filed," instead of "furnished," which means its contents are subject to legal liability under federal securities laws and subject to Section 302 certifications by the chief executive and financial officers under the Sarbanes-Oxley Act. [For more information about CD&A, see Appendix B on page 10.](#)

### **Disclosures will be long and complex; filers may wish for more regulatory clarity**

Participants have started to review early drafts of the CD&A. Many have been struck by the fact that even a company with no defined benefit plan is required to submit *"an additional 20–25 pages of proxy disclosure, [which is] longer than some companies' entire proxy statements now."* One participant added, *"For companies with defined benefits, restricted shares, long- and short-term incentives, perks, etc., [the CD&A disclosure] will be voluminous."*

Not only will the CD&A be long, it will also contain a significant amount of complex financial data. One participant noted that the information presented for a senior executive often includes *"things like the added contribution of his or her pension fund, his or her deferred comp, or the valuation of a severance package. All these require a lot of calculation, and they'd better be right."*

One participant lamented the fact that little tactical advice has been provided and complained, *"We'll have to figure the CD&A disclosure out on our own; no one will provide clarity to us ... More clarity from the SEC would have been appreciated."* Another participant offered a prediction: *"With everything going on [in early 2007], who's going to be able to [review and approve the CD&A disclosures]? It will be a fire drill, like [Section] 404 was the first time around."*

### **Board committee roles will evolve**

Although management, and not the board, is responsible for the accuracy of the CD&A disclosures, the compensation committee report must indicate whether the compensation committee has (1) reviewed and discussed the CD&A with management and (2) whether it has recommended to the board of directors that the CD&A be included in the company's annual report on Form 10-K and, as applicable, the company's

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<sup>2</sup> U.S. Securities and Exchange Commission, "SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters," press release, July 26, 2006, <http://www.sec.gov/news/press/2006/2006-123.htm>.

proxy or information statement.<sup>3</sup> These new board responsibilities have taken some participants by surprise. One member said, “[Until recently], it never occurred to me that the board would need to take an initiative to make sure [compensation] numbers are right.”

Some participants felt this was the responsibility of every director: “Put me in the camp of thinking that every director needs to look at the proxy and understand a lot more about the compensation plans.”

However, most participants felt CD&A oversight should be handled instead by a board committee:

- **Compensation committee review of CD&A.** Some participants believed “[CD&A] would be [exclusively] a comp committee responsibility. I don't think the audit committee is the proper place ... The audit committee wouldn't totally understand what went into the numbers on [compensation disclosures]. It's the compensation committee's charge.” This view is supported by attorney Stewart Landefeld of Perkins Coie, who says the analysis portion of the CD&A “is in the laps of the compensation committee members” because the compensation decisions included there are the heart of what the committee does.<sup>4</sup>
- **Audit committee review of CD&A.** One participant wondered, “[Should the audit committee] vet the numbers, or is that the [role of the] compensation committee? Should they involve the external auditor? The internal auditor? Consultants?” Many participants believe the audit committee has an important role to play. One participant said, “You rarely have financial people sitting in on comp committee meetings, and yet with all that's happening with regard to compensation, [there is a] need to ensure stronger internal controls over compensation ... [The problem] will only intensify. When I think about it ... the audit committee will [probably] look more at the comp committee information.” Others agreed: “The natural course of events will make the audit committees more involved in compensation reporting.”

### Internal and external audit may be asked to review compensation disclosures

Many participants expect internal and external auditors to play a role in reviewing the CD&A:

- **Internal audit review of CD&A.** Some participants agreed with one participant who said, “It makes sense to have the internal auditor review the [executive compensation] numbers,” but others felt internal audit might lack independence. One participant said, “[Internal auditors] are the wrong people to do it. Many people in internal audit hope to have another kind of job, usually in management, so that means that they are fussing with their bosses or future bosses. The issue is so public. They can do a little work, but it is the role of the external audit to do the in-depth work.”
- **External audit review of CD&A.** For many participants, “it's unclear what the external auditor's role will be.” One participant noted, “I don't think auditors vouch for numbers. [However,] we can have certain audit procedures to test things and vouch for [the effectiveness of] processes.” Another participant said, “We have asked [the external auditors] to do selective sampling and make sure they're comfortable with the numbers.”

<sup>3</sup> Troutman Sanders LLP, “Another Challenge for Directors: The SEC's New Compensation Discussion and Analysis,” [http://recruiting.troutmansanders.com/articles/securities\\_capital.pdf](http://recruiting.troutmansanders.com/articles/securities_capital.pdf).

<sup>4</sup> Melissa Klein Aguilar, “Compensation Committees In Line Of Fire.”

Although internal and external audit currently report to the audit committee, several participants envisioned an emerging relationship between both internal and external audit and the compensation committee: *“You’re going to see more comp committees going in that direction.”* This shift has implications for audit committees *“because the audit committee is [currently] involved in internal audit’s annual planning, and involved in fee negotiations and oversight if external audit does something.”*

### **Effective board and committee coordination is difficult but necessary**

Participants noted that board committees generally work independently of one another, with each committee having its own characteristic processes, people, and interpersonal dynamics. Participants observed that even though committee chairs report to the full board, those reports *“tend to be brief and really cannot get into the issues in depth.”* One participant said, *“I sit on one board where committees are separate, and the only thing we hear about comp is in a perfunctory report. There aren’t even a lot of questions. In our closed sessions, we say it doesn’t feel right. But a lot of it is the separateness with which the processes are organized – the timing of meetings, membership, and interpersonal stuff.”*

### **Not the right framework for deliberative conversation?**

Even when board committees work well, many directors are concerned that structural constraints impede careful consideration of the issues. One participant recognized that *“people are busy, and you spend so much time checking the boxes, but as a practical matter, it doesn’t leave that much time for comprehensive thinking.”* Another agreed that often the board committee model *“doesn’t create the right framework for a deliberative conversation.”*

Several participants stressed the importance of coordinating information flows and providing adequate time for each committee to reflect on the work of the others. As one participant noted, *“[It takes] a little bit of working jointly ... to get sequencing right and move the right amount of information back and forth. [Some] boards can be very passive about [ensuring that there is enough time for deliberation], and some can be active. Every board should be active.”*

### **Committee interdependencies**

Participants said that interdependencies between committees have only recently begun to become evident. As one member said, *“It’s interesting to me that [the relationship between] comp and audit [committees] is emerging more today. It was not as obvious before [the media focused on] stock option pricing and deferred compensation practices.”* However, there are several areas in which effective communication between the audit and compensation committees has always been important:

- **Ensuring proper controls are in place.** One participant said, *“In theory, the [compensation] controls are being vetted because they are subject to [Section] 404 requirements ... The mechanics are pretty daunting.”* Another participant said, *“The audit committee will probably need more information from the comp committee about virtually everything that’s going on in compensation, to be sure that controls are in place.”*

- **Assessing the implications of compensation for financial reporting.** *“On the audit committee, you need to understand the structure of [executive] compensation and where the sensitivities would be in regards to financial results. You need to understand what the comp committee has done with respect to embodying [its] philosophy. If you pay everybody on [earnings per share], and you see the capital budget has been cut, it sounds like you’re getting exactly what you set up in terms of incentives, but not necessarily what’s good for the [company]. You need to have a clear understanding of the potential implications of the comp structure.”*
- **Anticipating the likely magnitude and timing of incentives.** *“We need to know if [the incentive targets] are false goals. We have had to accrue and reverse big numbers. That is where compensation and audit need to be talking.”*
- **Adjusting compensation to reflect extraordinary events.** *“If performance is based on revenue growth or return on invested capital, someone has to oversee it to be sure that exogenous events haven’t intervened to affect those measurements.”* Participants stressed the need for consistent treatment over time; if negative extraordinary events are omitted in one period, positive extraordinary events should also be omitted in future periods.
- **Changing executive compensation practices.** *“If the compensation committee is going to recommend a significant philosophical change in incentive comp, [it] should send a formal [proposal] to the audit committee, and the audit committee should provide a formal response.”*
- **Stock option backdating.** According to a recent piece in the *Wall Street Journal*, “With more than 130 companies under federal scrutiny, the investigation into stock-option backdating has rapidly become one of the broadest corporate scandals in decades.”<sup>5</sup> Given that the issue touches both the audit and compensation committees, participants questioned which should take the lead in investigating allegations of impropriety and ensuring the integrity of the disclosures going forward. One participant said, *“It could be either, but the other committee needs to be very much involved and informed.”* Participants generally agreed that *“the compensation committee sets the [options grant] policy, and the audit committee has a responsibility for overseeing the control environment.”*

### The board acting in concert

Several participants said that while independent board committees are efficient, they are not always the most effective way to examine complex issues. One participant said, *“In the current environment, it’s been healthy to have more board engagement with what some of the committees are doing. It’s changing the entire dynamic of being a director.”*

Another participant agreed that issues increasingly need to be addressed by a *“committee of the whole board.”* This participant said, *“There is value in the division of labor and doing things in committees, but the board should [also] do many things [together]. It’s unfortunate, but understandable.”*

Several participants believe the full board needs to be engaged in executive compensation discussions. After all, *“Certain things are too important to delegate to the compensation committee – like CEO or CFO*

<sup>5</sup> James Bandler and Kara Scannell, “In Options Probes, Private Law Firms Play Crucial Role,” *Wall Street Journal*, October 28, 2006, A1.

*contracts.” One participant said that full board discussions of executive compensation lead to “better board support and better understanding ... I would argue that it’s time well spent.”*

## Some companies are adopting new mechanisms to coordinate committee activities

Clearly, much of the coordination between committees will still occur during full board meetings. One participant said, *“I think the comp committee is going to be giving very comprehensive reports to the full board, so the audit committee will get the report with the rest of the committees.”* Stressing the need for boards to devote adequate time to compensation issues, another participant expected the compensation committee report to take at least an hour during the January board meeting.

Given the overlap between audit and compensation issues, one participant wondered whether *“companies [have] started the process of finding where the intersections are, and whether there is a process in place to determine if appropriate communication and interaction [between board committees] is in place.”*

Participants discussed several mechanisms they have found to be effective in improving coordination and communication between committees. While no new practice is without drawbacks, participants felt that the following coordination mechanisms merit further consideration:

- **Joint meetings:** Although some audit and compensation committees schedule joint meetings periodically to discuss specific issues, this practice is not very widespread.
- **Committee cross-membership:** Several participants noted it was helpful to have one or more directors with *“knowledge of the working of both committees.”* Some boards ask the audit and compensation committee chairs to serve on each other’s committee. More often, however, cross-membership is an unintended by-product of a small board with a limited number of independent directors.
- **More comprehensive information:** Some companies share all committee reports with every director to be sure the entire board is fully briefed on key issues. Although some participants felt this could be a helpful practice, others were concerned it might result in *“overloading the boards with data.”*
- **Open invitations:** One participant said, *“There is an open invitation for [board] members to sit in on committee meetings other than their own if they have time. I look through the agendas to see if there are any topics I should be aware of and would like to get involved in.”*
- **Informal interactions between chairs:** One participant finds it helpful to travel to board meetings with a fellow committee chair who lives nearby: *“This is a practical way of understanding what’s going on and making sure that materials and information are shared.”*
- **CEO advisory committee:** Some participants described the value of a CEO advisory committee composed of the audit, compensation, and governance committee chairs. One participant said that such a group makes it *“very easy for us to exchange a lot of thought. I think that works as an informal [coordination] mechanism very well.”*

Participants also noted the value of audit committee experience for compensation committee members. One participant stated, *“The best person for the comp committee chair is someone who has been on the audit*

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*committee for some time.” Another participant reflected that “being on the audit committee [does not] makes me any better at comp, it just makes me more alert to the financial reporting of the company. You pore over huge amounts of data, and you simply have more exposure.”*

## Conclusion

It is often said that form follows function, and it is in this spirit that the nature and frequency of board committee interactions have evolved to achieve a desired objective. However, as audit and compensation committees address new responsibilities, including those associated with regulatory disclosures, the current modes of interaction and coordination may no longer be as effective as they once were. It is inevitable that new relationships and new work flows will prompt new discussions within and across board committees.

The questions are only now emerging, and there will be no easy answers. As one participant wisely suggested, *“The best thing is to always be listening, having advisers so you know what’s happening. You have to remain alert to what the implications [of change] are for the committees and the full board.”*

## About this document

*InSights* is produced by Tapestry Networks to provide assessments of key issues of interest to audit committees. Initially, *InSights* will be distributed to members of audit committee networks sponsored by Ernst & Young and orchestrated by Tapestry Networks, who, in turn, will share it with colleagues on audit committees and boards, and their advisers. It will be distributed by Ernst & Young to its partners. Anyone who receives *InSights* may share it with those in their own network. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view.

*The views expressed in this document represent those of the individuals who participated in the research. 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 U.S. member firm of Ernst & Young LLP.*

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## Appendix A – Participants’ public company audit and compensation committees

| Participant           | Audit committees*  | Compensation committees*   |
|-----------------------|--|--|
| Eddie Adair           | <b>PSS/World Medical, Tech Data Corporation</b> , Torchmark  | <b>Performance Food Group</b> , Tech Data Corporation  |
| John Dillon           | Caterpillar, DuPont, <b>Kellogg</b>  | <b>DuPont</b>  |
| Gordon Harnett        | EnPro Industries, <b>PolyOne Corporation</b>   | <b>Lubrizol</b>  |
| Sherrill Hudson       | <b>Publix Supermarkets, Standard Register</b>  | Publix Supermarkets, Standard Register   |
| Bill Lawrence         | Brush Engineered Materials, Ferro  | Ferro  |
| Mike Losh             | <b>AMB Property</b> , Cardinal Health, <b>H. B. Fuller</b> , MASCO Corporation, <b>Metaldyne, TRW Automotive</b> | AON, MASCO Corporation, Metaldyne  |
| Vic Pelson            | <b>Dun &amp; Bradstreet, Eaton</b>   | Dun & Bradstreet, <b>UPS</b>   |
| Paula Rospot Reynolds | <b>Coca-Cola Enterprises</b>   | Delta Air Lines, Coca-Cola Enterprises   |
| Paul Smith            | <b>Constellation Brands, Home Properties</b>   | Constellation Brands   |
| Bill Smithburg        | Abbott Laboratories, <b>Corning</b>  | <b>Abbott Laboratories</b> , Corning, Northern Trust, <b>Smurfit-Stone Container Corporation</b> |
| Peter Ueberroth       | <b>The Coca-Cola Company</b>   | <b>Adecco</b> , Hilton Hotel Corporation   |
| Sandy Warner          | Anheuser-Busch Companies, <b>General Electric Company</b>  | General Electric Company   |

\*Member is the committee chair for companies in **bold**.

## Appendix B – Compensation discussion and analysis: background Q&A

The board compensation committee report on executive compensation has been replaced by a more concise document called the compensation committee report. The compensation discussion and analysis, a new section required by the SEC, will address the objectives of executive compensation programs. The summary compensation table will be the principal disclosure vehicle for executive compensation, showing compensation for each named executive over the last three years. Companies will provide additional disclosures regarding company programs, plans, and practices relating to the granting of options and the timing of option grants. The SEC also requires a table covering the potential annual payments and benefits of the company's retirement plans; this table is meant to provide investors with a clearer picture of overall executive retirement packages.<sup>6</sup>

### What is the CD&A?

The CD&A is intended to communicate the company's overall strategy for awarding compensation to executives. The CD&A should describe (1) the company's compensation objectives, (2) what the compensation programs are designed to reward and not reward, (3) why the company chooses to pay each element of compensation, (4) how the company determines the amount or formula for each element of compensation, and (5) how each compensation element and the company's decisions regarding it fit into the company's overall compensation objectives.

According to Jeffrey Gordon, a professor at the Columbia Law School whose work influenced the SEC's proposal of the CD&A, "The CD&A should provide a bottom line assessment of the different compensation elements ... and then a justification in light of the demands of the job, the particular market, the actual performance, and the like; in short, an explanation of why the compensation committee thinks the compensation is warranted."<sup>7</sup>

### How is the CD&A different from the compensation committee report?

Initial drafts of rules from the SEC proposed that the CD&A replace the compensation committee report entirely. However, in the final text of the disclosure rules, the SEC added back a briefer version of the committee report along with the CD&A narrative. The vast majority of the content required in the current compensation committee report, including discussion of compensation policies, practices, and performance criteria, will be included in the new CD&A narrative.

### How does the compensation committee report compare with the audit committee report?

Companies will be required to include the compensation committee report (or to incorporate it by reference) into the company's annual report on Form 10-K, so that it is presented along with the CD&A

<sup>6</sup> For the full text from the SEC, please refer to U.S. Securities and Exchange Commission, *Executive Compensation and Related Person Disclosure*, Release nos. 33-8732A; 34-54302A; IC-27444A; File no. S7-03-06 (Washington, DC: Securities and Exchange Commission, 2006), 41-43. Available online at <http://www.sec.gov/rules/final/2006/33-8732a.pdf>.

<sup>7</sup> Jeffrey Gordon, *Executive Compensation: What's the Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis"* (New York: Columbia Law School Center for Law and Economic Studies, 2005), 19. Available at [http://www.pay-without-performance.com/Gordon\\_Executive-Compensation-What's%20the-Problem.pdf](http://www.pay-without-performance.com/Gordon_Executive-Compensation-What's%20the-Problem.pdf).

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when that disclosure is provided in the Form 10-K or incorporated by reference from a proxy or information statement – something that is not required for the audit committee report. Like the audit committee report, the compensation committee report will only be required once during any fiscal year. The name of each member of the company’s compensation committee (or, in the absence of a compensation committee, the persons performing equivalent functions or the entire board of directors) must appear below the disclosure.