



## Executive compensation: a role for the board and the audit committee

### Introduction

The Pacific Southwest Audit Committee Network (PSWACN) held its 13th meeting on June 24, 2009, in Santa Monica, CA. Network members, who sit on the boards of more than 25 large-, mid-, and small-cap companies between them, discussed the role of the board in overseeing executive compensation and explored opportunities for greater alignment between the audit and compensation committees.<sup>1</sup> For a full list of participants, see Appendix 1 (page 7).

### Executive summary

In light of the increased focus of politicians, investors, and the public on executive pay packages, network members expressed an interest in sharing practices that support effective oversight of executive compensation. Discussion covered four broad themes:

- **Executive compensation in context: why does it matter?** (*Page 2*)

The increasing likelihood of regulatory intervention, coupled with heightened public scrutiny of executive pay packages, has prompted boards to pay more attention to the issue of executive compensation. Network members blame the financial services sector for the populist outrage over excessive executive compensation, but believe that repercussions will be felt across all industries.

- **The full board has increased its involvement in executive compensation** (*Page 2*)

In today's environment, all directors are responsible for understanding the philosophy and metrics behind the compensation plan, even though the compensation committee retains primary responsibility for developing it. Directors who do not serve on the compensation committee seek a deeper understanding of the potential payouts under a range of scenarios.

- **Risk, strategy, and compensation are inextricably linked** (*Page 4*)

Members agreed the board must recognize and take into account the links between risk, strategy, and compensation. Network members advocated an explicit discussion of executive compensation during the annual strategic plan review. While the board should be thoughtful about linking risks and rewards, members cautioned that it is important to avoid becoming excessively risk averse.

- **The audit committee can support the compensation committee** (*Page 5*)

Network members agreed they are not looking to expand the audit committee's scope of responsibility to include executive compensation. However, should their input be solicited, they pointed out that audit committee members have a great deal to offer. In particular, audit committees can help clarify definitions and treatment of adjustments and can offer broad financial expertise and an appreciation of risks.

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<sup>1</sup> *VantagePoint* 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 comments made by PSWACN members during and after the June 24 meeting.



Members agreed that specific mechanisms to ensure alignment between the audit and compensation committee are less important than a spirit of continuous, open dialogue. External auditors may be a meaningful source of help, given their familiarity with the company's financials and their exposure to a broad range of companies in an industry.

### Executive compensation in context: why does it matter?

As a leading compensation consultant observed, "Few issues stir up more controversy, resentment, and debate among investors, executives, board members, politicians, and everyday citizens than executive compensation, especially in a period of economic downturn."<sup>2</sup> The combination of a new administration, an emboldened Congress, a financial bailout bill with far-reaching provisions, and heightened shareholder scrutiny has resulted in vigorous calls for compensation reform in 2009.

The shareholder rights bills put forward by Senator Charles Schumer (D-NY) and Congressman Gary Peters (D-MI), which contains provisions for say on pay, and the recent proposal from the Securities and Exchange Commission (SEC) regarding proxy access have the potential to change the corporate governance landscape significantly. As one member put it, *"People are going to put stop signs in places we've been driving through before, and they are going to start writing tickets."*

Members reported that the issue of nonbinding shareholder votes on executive compensation (say on pay) remains one of the most prominent topics of conversation at the board level. With President Obama supporting mandating say on pay, many believe that it is only a matter of time before the legislation is signed into law,<sup>3</sup> and PSWACN members concurred: they predict that the public's anger over what it deems excessive executive compensation will lead to further legislative action in 2009.

Many members believe misaligned compensation packages at financial institutions amplified the public outcry over excessive compensation, leaving members to wonder if their companies are unfairly feeling the repercussions of the financial sector's actions: *"Do you think corporate America in general is being drafted into problems of financial institutions? The risks they took were huge. However, the risks relative to performance at our companies are not nearly the same level as [at] financial institutions."* Regardless, members agreed that *"the average compensation plan is getting sucked in, and you're swimming upstream to try and stop this. Executive compensation has ticked off so many people that I just don't think we're going to win the argument."*

### The full board has increased its involvement in executive compensation

While historically the board's involvement in executive compensation has often been limited to *"blessing the plan"* that was presented annually by the compensation committee, members reported that the heightened scrutiny of executive compensation has prompted the full board to become increasingly engaged.

<sup>2</sup> Fred Cook, "Executive Compensation 2008: The Year in Review & The Road Ahead," alert letter, April 28, 2009, 2. Available at [http://www.fwcook.com/alert\\_letters/04-28-09-Exec-Comp-2008-The-Year-in-Review-&-The-Road-Ahead.pdf](http://www.fwcook.com/alert_letters/04-28-09-Exec-Comp-2008-The-Year-in-Review-&-The-Road-Ahead.pdf).

<sup>3</sup> Melissa Klein Aguilar, "What's in Store for 2010 Proxy Season?" *Compliance Week*, June 23, 2009. Available at <http://www.complianceweek.com/article/5464/whats-in-store-for-2010-proxy-season->.



Members agreed that every director should understand how the company incents and rewards its executives: *“It is incumbent on all independent board members in today’s environment to understand the philosophy [and] judgment around the compensation plan and what the metrics mean.”* Added another member, *“Things have now evolved to a point where board members need to understand exactly how executives are paid and rewarded, how that plays out over time, and how it links to strategy. Otherwise you have your head in the sand, and you’re governing as an ostrich.”*

While members pointed out that *“how actively boards get involved depends on the company,”* many see a clear trend: *“Things we may have been willing to delegate to a committee in the past might not be feasible anymore. We now need the full board making these decisions.”*

### **The compensation committee still drives executive compensation**

Despite the full board’s increased engagement, members agreed that the compensation committee continues to play the leading role in compensation oversight. At most companies, the compensation committee continues to determine the details of the compensation plan and ensures that performance metrics are aligned with the board’s philosophy: *“In the end, it’s the compensation committee’s job to figure out the components and metrics of the plan.”* Added another member, *“The design is a compensation committee issue. Their job is to keep us from embarrassing ourselves.”*

Members agreed that timely, open communication between the compensation committee and the rest of the board is more important than ever. Specifically, the compensation committee should ensure the board is adequately briefed on any significant changes (e.g., short-term versus long-term incentives, number and nature of metrics, the appropriate mix of equity vehicles). One member lamented an instance in which the board was not sufficiently apprised of a change: *“When the compensation committee recently changed [from options] to [restricted stock units] ... I don’t think the committee did a good job cluing in the board on that significant change in direction.”*

### **Scenario analysis can help minimize surprises**

Members generally agreed that directors who do not serve on the compensation committee need a better understanding of possible payouts under a range of scenarios: *“We ask the compensation committee to do five-year projections so we can discuss what might happen. We don’t want any surprises, and this way, we don’t get surprised by the numbers if we’ve had that conversation beforehand.”*

Moreover, members pointed out that thoughtful sensitivity analyses can reduce reputational risks: *“We put scenarios on all of these elements of compensation and see how they would look if stock goes to ‘x.’ [We] look at how things will look this year, next year, and the third year. It helps to avoid headline risk [the risk of a negative media story] if you do that.”* Still, members agreed that recent events have shown how difficult it is to make accurate predictions: *“What we didn’t do [before] is consider what would happen if you were three [standard] deviations from the norm.”*



## Risk, strategy, and compensation are inextricably linked

Many observers have said that the economic crisis revealed vulnerabilities in the way public companies motivate and reward their executives: “The crisis exposed flaws in exec compensation, showing the system encouraged risk-taking without an appreciation of the ramifications, which in some cases were entity threatening.”<sup>4</sup> Many members concurred, taking issue with compensation plans that incent management to take excessive risks in an effort to maximize short-term payouts. As one member pointed out before the meeting, “We’ve seen compensation systems that are overly aggressive ... encouraging management to take risks, either explicitly or subconsciously. You can make an argument that, historically, they were designed with performance in mind, rather than risk in mind.”

Members recognized that poorly designed compensation plans can create unanticipated risks and stressed the importance of linking compensation measures to the company’s strategy: *“I distinguish the board’s role in compensation plan design as understanding the measures and objectives and making sure [compensation] is effectively linked to the board’s strategic plan.”* While this sounds simple, members said it is an ongoing challenge for many boards: *“It’s important to have a common understanding of overall strategy and how well it is linked to the compensation plan. There is not always a good understanding of that amongst board members.”*

The SEC is now proposing a set of rule revisions intended to improve the compensation and governance disclosures provided to shareholders of public companies. These rules would require provision of information about the relationship of a company’s overall compensation policies to risk.<sup>5</sup>

One member proposed a mechanism to ensure tighter alignment between risk, strategy, and compensation: *“Every year we go away for two days and talk about strategy. We design and review our three-year, five-year, and ten-year plan. What if, when we have our strategic planning meeting, we spend one hour in discussion as a full board and ask if there’s anything in the plan that’s not congruent with the current executive compensation plan? It would allow us to really dig in on these issues as a board.”*

Members generally agreed this practice warranted serious consideration, with one caveat. In a conversation after the meeting, one member pointed out, *“People are pretty tired at the end of a two-day strategy session, and the idea of taking an hour and stepping back and having that conversation around executive compensation – which is a tiring issue as it is – sounds like a bit much. One thing we do is [incorporate] those discussions around compensation throughout the entire strategy session.”*

Although they agreed compensation plans should align risks and rewards, members said boards must guard against becoming excessively risk averse: *“We need to be careful that risk is not [seen as] this horrible thing, and God forbid you take a risk and get rewarded for it. People think risk management is risk avoidance, and that’s not right at all. We need to really watch out for that in this environment.”*

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<sup>4</sup> Alistair Barr and Matt Andrejczak, “The executive pay system is broken,” *Market Watch*, May 12, 2009. Available at <http://www.marketwatch.com/story/print?guid=232BB327-8FDC-4D6C-94ED-7B2CD95AF88A>.

<sup>5</sup> More details about the SEC’s proposals can found at US Securities and Exchange Commission, “SEC Proposes Measures to Improve Corporate Governance and Enhance Investor Confidence,” press release, July 1, 2009. Available at <http://www.sec.gov/news/press/2009/2009-147.htm>.



## The audit committee can support the compensation committee

Members agreed that committee charters are clear, and they have no intention of expanding the audit committee's scope of responsibility to include executive compensation. However, they pointed out that the audit committee can make important contributions to the compensation oversight process.<sup>6</sup> Specifically, members suggested that they can assist in the following areas:

- **Clarifying definitions and ensuring proper treatment of accounting adjustments.** In recent months, many companies have reported goodwill impairments and asset write-downs. Members noted that compensation plans often fail to clearly define the terms of US Generally Accepted Accounting Principles (GAAP) and non-US GAAP metrics. Several members suggested that the audit committee could assist the compensation committee in designing clear metrics that anticipate a more comprehensive range of possibilities. One problem is that some adjustments are driven more by accounting rules than by financial performance, and therefore it is not always clear whether management should be held accountable: *"Ofentimes accounting is clear, but whether or not it affects compensation is a judgment call."* In those situations, audit committees could help the compensation committee discern which adjustments reflect technical accounting changes and which represent a change in actual shareholder value.

In addition to goodwill impairments and asset write-downs, members reported that *"clawbacks are getting some attention."* Clawback provisions are often triggered by a prior-period restatement and suggest past management compensation was not justified. Recent data suggest adoption of clawback provisions is on the rise: "More than 63 percent of the Fortune 100 now have them in place, up from 17.6 percent in 2006."<sup>7</sup> Members said the audit committee has a potential role to play in understanding how to address clawback issues following financial restatements.

- **Providing broad financial expertise.** One member said, *"We, as finance experts, flatter ourselves that we understand the numbers of the company more than some of our fellow directors."* Members agreed that the audit committee can often contribute its expertise in reviewing the quantitative aspects of compensation, including the compensation discussion and analysis (CD&A) in the proxy: *"Many of us on the audit committee can assist the compensation committee with the numbers and help them with the quantitative assessment of performance."* While members acknowledged that the compensation committee often includes financially savvy directors, one member asserted that *"a good, collegial board should always ask for the second opinion of the audit committee."*
- **Identifying risks emerging from the compensation plan.** Meeting participants pointed out that audit committee members tend to have a deeper understanding of risk than most other directors, and therefore the audit committee might be helpful in identifying risks that could emerge from the compensation plan: *"The audit committee's link with executive compensation is through enterprise risk management, and to make sure compensation is not designed in a way to incent more risks than we have discussed."*

<sup>6</sup> For another perspective on these matters, see also Audit Committee Leadership Network, "Joint considerations for audit and compensation committees," *ViewPoints*, March 5, 2009. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_ACLN\\_Mar09\\_View26.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Mar09_View26.pdf).

<sup>7</sup> "Clawback Provisions on the Rise," *Directorship*, December 1, 2008. Available at <http://www.directorship.com/clawback-provisions-on-the-rise>.



### **Mechanisms to ensure alignment between committees**

Members agreed that alignment between the audit and compensation committee is important, but noted that this objective can be achieved in many ways. Some boards assign one or more members to serve on both the audit and compensation committee, either by design or by chance. As one audit committee chair said prior to the meeting, “My situation is very much flavored by the fact that we have overlapping committee members, so we have an ongoing dialogue. Nothing is coming as a surprise to either committee.” While members broadly agreed on the benefits of committee cross-membership, they did not believe it was critical to effective governance and acknowledged that the practice may be impractical when committee meetings are held concurrently.

At a minimum, members agreed on the importance of ongoing, informal communication between committee chairs. One member reported, *“It is not unusual for the compensation committee chair to include the audit committee chair in discussions around executive compensation.”* Another member noted prior to the meeting, “After almost every board or committee meeting, the compensation committee chair and I have telephonic communications.”

### **The external auditor’s role**

Audit and compensation committees rely heavily on auditors, consultants, and legal counsel to support their oversight responsibilities. While external auditors have little to no direct responsibility for executive compensation, members said the auditors bring a deep understanding of the company’s financials and an exposure to a broad range of businesses: *“The auditors understand our attitude and how the numbers are determined. They also see more than we do outside the company, so they can bring that to our attention. We directors should consider all areas where auditors might be able to help us more.”*

Meeting participants pointed out that the auditors can review the numbers in the CD&A and be *“looking for the trigger mechanism [for incentive compensation] that is most sensitive.”* Additionally, auditors can often provide a balanced perspective: *“Our auditors did a good job serving as a counterbalance to the compensation consultants. We were looking for what’s right and what’s fair, and they were able to put things in more pragmatic tones ... what the ramifications of certain stock plans would be.”* Ultimately, members agreed with the member who remarked, *“Audit committees that are on their toes should be asking auditors what they think about these issues.”*

### **Conclusion**

Network members emphasized the importance of ensuring effective board processes are in place, given the turbulent economic environment and heightened public scrutiny of executive compensation. As audit committees consider how they can work more effectively with the compensation committee to oversee risk and reward, some suggest that compensation is part of the broader governance issue: *“I think this issue of executive compensation is a symptom of a larger problem around how you govern yourself. How does a board stay in touch with what’s going on and have sufficient knowledge to challenge management in how it gets paid?”*



## **Appendix 1: Meeting participants**

The members of the network present at the meeting were:

- Henry DeNero, Audit Committee Chair, Western Digital
- Ray Dittamore, Audit Committee Chair, Life Technologies
- David Engelman, Audit Committee Member, Fleetwood Enterprises
- Stephen Frank, Audit Committee Chair, Northrop Grumman
- Diana Laing, Audit Committee Chair, Macerich
- Louis Lavigne, Audit Committee Chair, BMC Software
- Marty Melone, Audit Committee Chair, Internet Brands
- Mike Meyer, Audit Committee Member, City National Corporation
- Roger Molvar, Audit Committee Chair, CapitalSource Bank
- Stephen Page, Audit Committee Chair, Lowe's Companies
- Michael Stein, Audit Committee Chair, AIMCO

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

- Frank Biondi, Audit Committee Chair, Amgen
- Richard Dahl, Audit Committee Chair, DineEquity
- Sue Redman, Audit Committee Chair, The Apollo Group
- Orin Smith, Audit Committee Chair, The Walt Disney Company

Ernst & Young partners participating in the meeting included:

- Bill Browning, Los Angeles County Office Managing Partner and Pacific Southwest Sub-Area Accounts and Business Development Leader
- Peter Griffith, Pacific Southwest Sub-Area Managing Partner



## Appendix 2: Questions for audit committees to consider

- ? What is the most effective way to set executive compensation? What is the appropriate role for directors who do not serve on the compensation committee? How and when should these directors participate in the process?
- ? How has the economic crisis impacted the board's discussions of executive compensation? What changes are likely as a result of increased public and shareholder focus on compensation?
- ? How explicitly do boards consider the relationship between risk and executive rewards? How might such discussions be made more robust? How would the relationship between risk and compensation be disclosed under the SEC's latest proposed rule change?
- ? What elements of the audit committee charter are associated with oversight of executive compensation, either directly or indirectly? How might that evolve in the future?
- ? How can audit committees ensure that engagement with executive compensation issues is not perceived as overreach?
- ? What role, if any, might the external auditor play in supporting the board's design and deployment of an effective executive compensation plan?
- ? How might auditors and compensation consultants work together more closely to support the board and its committees?
- ? What issues deserve the shared attention of the audit and compensation committees? What mechanisms might be employed to ensure adequate consideration is given to these issues?
- ? What are the advantages and disadvantages of committee cross-membership?

### About this document

The Pacific Southwest Audit Committee Network is a group of audit committee chairs drawn from leading 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.

*VantagePoint* 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 *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *VantagePoint* 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.

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