



## Enhancing trust and competition in global public capital markets

### Introduction

On February 21, 2007, members of the European and North American Audit Committee Leadership Networks met to discuss issues that are currently shaping their roles as audit committee chairs and that impact the networks' mission to enhance trust in capital markets.

In conversation with guests from the New York Stock Exchange Group (NYSE), the U.S. Securities and Exchange Commission (SEC), and the Public Company Accounting Oversight Board (PCAOB), members discussed the competitiveness of capital markets, the future of financial reporting, and the global role of the PCAOB. They concluded the day by reflecting on lessons learned from the accounting scandals of the early 2000s.<sup>1</sup> For further information on the networks, see "About this document," on page 11.

Members came up with four recommendations to stimulate both trust and competition in capital markets:

- **Rationalize the regulatory and litigation environment and the role of the SEC**
- **Simplify accounting standards and remove the need for reconciliation between International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (U.S. GAAP)**
- **Strengthen the public company accounting profession**
- **Improve oversight of executive compensation**

Guests who participated in separate discussions at the summit included:

- Mr. Conrad Hewitt, Chief Accountant, and Ms. Julie Erhardt, Deputy Chief Accountant, U.S. Securities and Exchange Commission
- Mr. Mark Olson, Chairman, Public Company Accounting Oversight Board
- Mr. John Thain, Chairman and Chief Executive Officer, New York Stock Exchange Group

Network members participating in the meeting included:

- Mr. Tom de Swaan, Audit Committee Chair, Royal Ahold and GlaxoSmithKline
- Mr. Per-Olof Eriksson, Audit Committee Chair, Volvo
- Mr. Gene Fife, Audit Committee Chair, Caterpillar
- Sir Anthony Greener, former Audit Committee Chair, BT
- Mrs. Judith Richards Hope, Audit Committee Chair, Union Pacific
- Ms. Marie Knowles, Audit Committee Chair, McKesson
- Mr. Daniel Lebègue, Audit Committee Member, Alcatel-Lucent
- Mr. Anders Nyrén, Audit Committee Chair, Skanska and Sandvik
- Mr. Oscar Munoz, Audit Committee Chair, Continental Airlines
- Mr. Chuck Noski, Audit Committee Chair, Microsoft and Morgan Stanley

<sup>1</sup> Audit Committee Leadership Summit, "Four lessons for audit committees from high-profile accounting scandals," *ViewPoints*, April 6, 2007. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_Summit\\_View2\\_Apr07.PDF](http://www.tapestrynetworks.com/documents/Tapestry_EY_Summit_View2_Apr07.PDF).

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- Sir Ian Prosser, Audit Committee Chair, BP
- Dr. Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Mr. Gerhard Schulmeyer, Audit Committee Chair, Zurich Financial Services
- Mr. Sandy Warner, Audit Committee Chair, General Electric Company

The members listed above sit on the boards of more than 60 large-, mid-, and small-cap public companies between them. Members from Ernst & Young participating in the discussion included:

- Mr. Tom Flannery, Americas Director, Audit Committee Communication
- Mr. Patrick Gounelle, Chairman of France and Southern Europe
- Mr. Steve Howe, Americas Managing Partner
- Mr. Tom McGrath, Managing Partner, Northern Europe, Middle East, India and Africa Client Service

*ViewPoints* reflects the networks' use of a modified version of the Chatham House Rule whereby names of members, guests, and company affiliations are a matter of public record, but comments made by members before and during meetings are not attributed to individuals or corporations. However, Mr. Hewitt, Ms. Erhardt, Mr. Olson, and Mr. Thain have given permission for their comments to be attributed. Mr. Hewitt's, Mr. Olson's, and Ms. Erhardt's comments represent their personal opinions and do not reflect those of the SEC, the PCAOB, or their staffs.

## Executive summary

This first-ever Audit Committee Leadership Summit brought together the European and North American Audit Committee Leadership Networks to begin to find common ground on how audit committees can help enhance trust in the world's public capital markets. The outcome of intensive discussions at the summit was a set of four recommendations to strengthen public capital markets:

- **Rationalize the regulatory and litigation environment and the role of the SEC** (*page 3*)

In spite of recent attention on reducing issuers' costs of compliance with Section 404 of the Sarbanes-Oxley Act, members identified a number of other, more pressing issues that, if resolved, could help instill greater trust in capital markets, such as changes in the SEC's approach and litigation reform. Many members representing large global public companies believe that changes in PCAOB and SEC guidance on implementing Section 404 won't change their compliance efforts or costs substantially.

- **Simplify accounting standards and remove the need for reconciliation between IFRS and U.S. GAAP** (*page 6*)

Members differ on whether IFRS, U.S. GAAP, or a combination are the best foundation for one global set of accounting standards, but all guests and members essentially agree that one simplified standard would be best. Unless something is done to simplify accounting standards, members feel they will continue to spend time on less value-adding activities, such as reconciling accounts, and may ultimately end up overseeing the creation of financial statements that become meaningless to investors.



- **Strengthen the public company accounting profession** (page 8)

Members and auditors may be converging on a shared understanding of the vulnerability of the profession and the potential impact on public capital markets of losing one of the Big Four, but they have sharply different views on the PCAOB inspection process.

- **Improve oversight of executive compensation** (page 9)

Members and some guests condemned stock option backdating scandals, but fear the fallout from new executive compensation disclosures, which could give capital markets another “*black eye*,” such as they received from implementing Section 404. They identified a number of steps that audit committee chairs can and should take today to help mitigate the negative impact of disclosures on investor and regulator confidence.

## **Rationalize the regulatory and litigation environment and the role of the SEC**

It was very clear from pre-meeting discussions that network members think the regulatory environment, particularly in the United States, is a serious factor in determining the level of trust public capital markets enjoy. On the one hand, strong regulation can make markets more enticing for investors; on the other, regulatory overreach can create a costly compliance burden for current and potential registrants. If members had any doubts about the U.S. regulatory environment’s influence on capital market dynamics around the world (and on the role of audit chairs themselves), those doubts were put to rest at the summit. Members shared their challenges navigating the regulatory environment, and one European member observed that the discussion wasn’t likely to “*raise any sympathy with potential EU listees.*”

### **Section 404 of Sarbanes-Oxley: mountain or molehill?**

In considering regulatory effects on U.S. markets, many stakeholders turn first to Section 404 of the Sarbanes-Oxley Act. Its influence has taken them by surprise: the SEC’s original estimated costs of Section 404 compliance were orders of magnitude lower than companies’ actual costs. The PCAOB’s Mark Olson stated, “*I have had many conversations with people who, to this day, are surprised and puzzled that 404 became so costly. Because it was drawn almost word for word from the FDIC Improvement Act of 1991, in their opinion, 404 did not seem to be a provision that was going to add to the audit costs.*”

While generally willing to concede that Section 404 implementation is a problem, most prefer to keep the legislation intact. Warning against throwing the “*baby ... out with the bathwater*,” John Thain of the NYSE noted, “*SOX has been mostly good – it’s shifted power back to the board of directors.*” He continued, “*the problem is the way 404 was implemented. There was no clear direction on materiality or a risk-based approach, and it’s consuming a lot of money and time, much more than the SEC estimated.*” In assessing how Section 404 implementation became an issue, Mr. Olson made this observation: “*There were many factors at play, including a very risk-averse environment.*”

Conrad Hewitt of the SEC noted that the burden of Section 404 implementation has been especially crushing “*for smaller companies*” that lack the well-developed internal audit functions that larger companies rely on to comply with the legislation.

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Network members indicated that proposed changes to Section 404 are welcome, but won't have very large effects for many of the larger registrants on whose boards members sit. Their reductions in Section 404 compliance costs are likely to amount to no more than a rounding error rather than material savings. Furthermore, audit chairs are wary of reducing Section 404 compliance because they believe so doing may increase exposure to regulatory scrutiny or litigation. Nonetheless, both Mr. Olson and Mr. Hewitt said they expect companies of all sizes to save money on compliance. Both also stated that, in their view, audit chairs should engage in a constructive dialogue with their auditors to ensure audit scope takes full advantage of the new regulatory guidance.

## **Meaningful change: what could make the regulatory environment more rational?**

Members agreed that certain meaningful changes to the regulatory environment would “rationalize” both regulatory and compliance efforts. Rationalizing the regulatory environment would have two main effects. First, regulations would be more streamlined and efficient. Second, rationalized regulation would allow both registrants and regulators to make decisions that would help make capital markets themselves more efficient. Network members and some guests had several suggestions for ways to make the regulatory environment more rational, which would in turn enhance trust in capital markets:

- **Change in the SEC's approach.** Members are concerned about the rise in restatements in 2006.

Despite building strong accounting capabilities in-house and taking counsel from accounting firms that are constantly engaged in dialogue with the SEC, members sometimes feel they are being sent the message that their well-founded judgments are irrelevant to the SEC. Furthermore, investors don't seem to react to such restatements, many of which are immaterial. One member aimed a pointed question at Mr. Hewitt in this regard: *“Why [were there] 1,700 restatements [in 2006] in the most sophisticated capital market in the world?”*<sup>2</sup>

Mr. Hewitt noted that *“there are many causes for restatements, including changes in accounting standards and the identification of issues as companies prepare for internal control evaluations under Section 404. In my experience, the SEC staff asks for a relatively small percentage of the restatements that occur each year. Most are identified by management and their internal and external auditors.”*

Still, several members described the SEC as *“running amok”* on issues such as review work (comment letters), enforcement, and extraterritoriality. Members brought up examples of ongoing conflicts with the SEC that are distracting them from what they deemed to be more important issues.

- **Litigation reform in conjunction with regulatory reform.** Mr. Thain stated that litigants may drain some life from the U.S. market if commonsense litigation reform doesn't accompany sound regulatory changes. Mr. Thain's advice: *“The UK model looks very attractive – the loser pays the legal fees, which gets rid of a lot of frivolous actions.”*

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<sup>2</sup> While several members expressed concern about restatements, recent research by Glass, Lewis & Co. presents a different perspective. In 2006, even though companies listed on U.S. public exchanges saw restatements increase 13% from the previous year, those companies that had already complied with Section 404 of Sarbanes-Oxley experienced a 14% decrease in restatements. In addition, in 2006, companies with more than \$75 million in annual revenues had 20% fewer restatements, while companies with less than \$75 million in annual revenue had 50% more restatements. For more information about the Glass Lewis research, please visit <http://www.webcpa.com/article.cfm?articleid=23560>.

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- **More reliance on foreign regulators.** Chairman Olson stated that the PCAOB’s *“intent is to increase our level of reliance on our non-U.S. counterparts in inspecting non-U.S.-registered audit firms,”* while Julie Erhardt of the SEC stressed that it is not part of the IFRS road map to rethink the Commission’s mandate to review disclosures made by non-U.S. issuers in U.S. capital markets. This approach is established in the securities laws set by Congress.
- **Exchange consolidation and subsequent regulatory convergence.** Mr. Thain articulated one of the ancillary benefits he believes will result from exchange consolidation: *“Over time, you’ll see regulatory consolidation by market forces that will mirror exchange consolidation.”* Capital markets are heading toward true seamlessness: *“There’s natural dialogue that’s occurring between the regulators now, and that will increase over time. A lot of this process started in Europe, with Euronext: they had to harmonize a number of regulations to have the cross-border exchange. It’s important to remember that we can’t export Sarbanes-Oxley – we have a number of protections in place to protect Euronext listees from this.”*
- **More management judgment in the internal controls process.** Mr. Hewitt believes the SEC’s guidance enables management to focus on *“what matters most for financial reporting ... [It] is principles based – [management and audit committees] should use sound business judgment, and the accounting firms should do the same.”* Members welcomed this approach wholeheartedly, but expressed skepticism that their companies and their auditors will be treated fairly should judgments come under fire from the SEC or PCAOB.
- **Avoiding regulatory undercutting of the audit profession’s authority.** Members declared their uneasiness with what they perceive as regulators’ undercutting of auditor authority. One member spoke of getting the same audit opinion from each of the Big Four accounting firms and still getting a negative opinion from the SEC. This undermines the value of auditor opinions and could undermine SEC efforts to encourage more judgment in the audit process.

## The roles and responsibilities of the PCAOB

Members were interested in the relationship between the PCAOB and the SEC. Created in 2002 as part of the Sarbanes-Oxley Act; the PCAOB oversees accounting firms that audit public companies in part by reviewing some of their clients’ audited statements and inspecting the audit firms’ operations and documentation for those audits.

At the summit, Mr. Olson provided these perspectives on the PCAOB’s role:

- **On the PCAOB’s regulatory style:** *“Our purpose is to help firms improve the quality of their auditing, where necessary. We do this through our active oversight and inspections, and use enforcement only when necessary.”*
- **On the PCAOB’s relationship with the SEC:** *“The SEC has oversight authority over the PCAOB, and its five Board members are appointed by the SEC. Among other things, it approves PCAOB’s budget and auditing standards.”*

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### How the SEC's Office of the Chief Accountant (OCA) can help

Mr. Hewitt and Ms. Erhardt offered to help as much as they can. In response to a question about dealing with comment letters, Ms. Erhardt stated that any registrant could request that a financial reporting matter which has arisen in an SEC staff review of their filing can be taken to the OCA for consideration. In her view, making such a request does not negatively affect the type of consideration that the matter will be given. In fact, Mr. Hewitt told members that if they bring concerns to the OCA earlier, *“the more time and attention OCA can give to the matter,”* and noted that *“the OCA can issue an interpretive letter”* where appropriate.

During the group's discussion of the volume of individually issued accounting pronouncements, Ms. Erhardt observed that issuing more separate pieces of guidance may seem likely to bring clarity to some, but warned that at the same time, the increased volume of guidance can create *“trip wires”* for those who don't pay close attention to the developments.

### Simplify accounting standards and remove the need for reconciliation between IFRS<sup>3</sup> and U.S. GAAP

Ms. Erhardt explained why the SEC supports the convergence of accounting standards: *“The premise of the IFRS road map is that the case can be made for one set of global accounting standards. As the road map states, various jurisdictions will use various routes to get there. An issue, then, is how does the U.S. contribute to that one set and how does the route we use affect the U.S. capital markets. In the U.S., we are using the convergence approach where we work to contribute to improved, high-quality standards.”*

Ms. Erhardt doesn't think that extending the reach of U.S. regulators is a viable strategy for creating one global set of generally accepted accounting principles. *“IFRS is not U.S. GAAP, and it is not my objective to turn it into U.S. GAAP through the work of the SEC staff. That is the context in considering matters under IFRS that arise in filings made with the SEC. Going back to the premise of the road map, one set of global accounting standards won't work if any jurisdiction owns it.”*

Members expressed a spectrum of opinions on IFRS and U.S. GAAP:

- **IFRS is superior due to its principles-based approach and should eventually supplant U.S. GAAP.** This view was held by several U.S. audit chairs as well as most European members. One member expressed it this way at the summit: *“A principles-based system is more attuned to the needs of a cross-border exchange.”*
- **Increasing amounts of IFRS guidance are likely to create a de facto rules-based standard, so why not use U.S. GAAP?** Some members believe that given the proliferation of guidance that will

<sup>3</sup> The International Financial Reporting Standards are principles-based standards of financial reporting that are believed to require significantly more accounting judgment for their application than do U.S. Generally Accepted Accounting Principles. They were developed by the International Accounting Standards Board (IASB) and have been implemented in almost 100 countries worldwide. EU listed companies were required to switch to IFRS in 2005, and now more than 7,000 companies in the EU report using IFRS. An accessible plain English description of IFRS is available at [http://www.ft.com/cms/s/f82a0a62-4176-11da-a45d-00000e2511c8,dwp\\_uuid=6cddc9b6-5cca-11da-a749-0000779e2340.html](http://www.ft.com/cms/s/f82a0a62-4176-11da-a45d-00000e2511c8,dwp_uuid=6cddc9b6-5cca-11da-a749-0000779e2340.html). More technical explanations are available at <http://www.iasb.org/Current+Projects/IASB+Projects/IASB+Work+Plan.htm>.



likely be issued by European regulators, there may end up being as little room for judgment in IFRS as there is in current U.S. GAAP. In that case, there would not be much difference between the standards in terms of usefulness, and U.S. GAAP could become the global standard.

However, for most members, the real concern about accounting standards is their complexity. One member quipped, *“I’d say that U.S. GAAP and IFRS are already equivalent because they’re both equally incomprehensible!”* If this is truly the case, then *“only talking about IFRS and U.S. GAAP [could be dangerous because] both will be circumvented by something people can really understand,”* such as analyses of financial statements provided by third parties.

With respect to the complexity caused by multiple interpretations, Ms. Erhardt stated, *“It is my experience that the [Financial Accounting Standards Board (FASB)] doesn’t go out and look for issues on which to provide interpretation. Rather, constituents call them with questions. Thus, any consideration of the volume of interpretations would need to look at who is calling them and why do they have incentives to do so.”* The SEC staff has also encouraged the FASB and the International Accounting Standards Board (IASB) to reduce complexity as they develop converged standards, and is considering setting up a “blue ribbon” commission in 2007 to identify other means of reducing complexity.

#### **Some questions regarding two sets of accounting principles in U.S. capital markets<sup>4</sup>**

Ms. Erhardt leads the SEC’s efforts to aid global accounting convergence. She noted that, during discussions about accounting standards with various constituencies, questions about the following kinds of topics are emerging:

- **Consequences and opportunities.** *“How would U.S. capital markets digest two sets of GAAP? What consequences and opportunities might that create, and for whom?”*
- **Competitive advantage among issuers.** *“If one company in a sector uses U.S. GAAP and another [in the same sector] uses IFRS, do [the company’s executives] feel like they are fairly competing for capital?”*
- **Competitive advantage among investors.** *“Does having two systems confer a competitive advantage on those investors who understand both systems relative to those investors that understand one system?”*
- **Eliminating or shifting reconciliation costs.** *“If the IFRS-to-U.S. GAAP reconciliation requirement were removed, would market forces drive issuers to provide reconciling information between IFRS and U.S. GAAP voluntarily? Or would investors attempt to estimate that information on their own? Thus, is this a matter of eliminating cost or shifting how it is incurred?”*

<sup>4</sup> These and other questions were also discussed at an SEC roundtable on March 6. For more information about the roundtable, please visit <http://www.sec.gov/spotlight/ifrsroadmap.htm>.

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With the stage set for moving toward one set of GAAP, members and some guests made the following observations:

- **Reconciliation provides very little value to investors.** Mr. Thain said, *“There’s no value added in taking IFRS statements and making them U.S. GAAP.”* Furthermore, one member – a foreign private issuer (FPI) – stated that *“reconciliation is a pointless exercise and wastes time and resources. Investors don’t care.”*
- **Mutual recognition is the way forward.** Members support mutual recognition of IFRS and U.S. GAAP, which Mr. Thain distinguished from equivalence: *“I wouldn’t call it equivalence; I’d call it mutual recognition. IFRS-compliant companies should be able to use those accounts in the U.S. and vice versa, period. Calling it mutual recognition gets around [the problem of] arguing whether the two are equivalent.”*

## Strengthen the public company accounting profession

Members and auditors may be converging on a shared understanding of the vulnerability of the global public company accounting firms and the potential impact on public capital markets of losing one of the Big Four. However, members, auditors, and other constituents have different views on the PCAOB inspection process.

## Sustainability and competition

In October 2006, leaders of the Big Four accounting firms and members of the European network gathered to discuss the future of the accounting profession. The sustainability of the audit profession was an important topic of the discussion. *ViewPoints* reported, “Members agreed that while a Big Five or Six would be desirable, the key was not to end up with a Big Three which would inevitably mean a ‘Big Zero.’ ‘That would be a disaster for most of us’ said one audit chair.”<sup>5</sup> Members of the North American network felt similarly when they discussed this issue in 2005.<sup>6</sup>

Chairman Olson said that he understood the concern about concentration in the accounting profession, *“But I think that the market will resolve any issues resulting from concentration among auditors.”* Chairman Olson acknowledged the drop-off from the Big Four to the next tier in terms of size and ability to handle large public company audits. For the PCAOB, he said, *“This means we want to make sure we are not doing anything to adversely affect industry concentration.”*

<sup>5</sup> European Audit Committee Leadership Network, “The future of accounting and the accounting profession,” *ViewPoints*, November 14, 2006, 8. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_Euro\\_ACLN\\_Nov06\\_View11.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_Nov06_View11.pdf).

<sup>6</sup> “In March 2005 members’ main concern is that the current system will be unsustainable if one of the Big Four fails. One member said it is inevitable that ‘... one of the Big Four will be behind a failing registrant. We all need to influence the process so that the integrity of the Big Four is not compromised when a blowup happens.” North American Audit Committee Leadership Network, “The future of the accounting profession,” *ViewPoints*, April 22, 2005, 5. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_ACLN\\_Apr05\\_View9.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Apr05_View9.pdf).

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### Contrasting views of the PCAOB inspection process

Mr. Olson stated that *“Our goal is to contribute to stability in the accounting profession through prudential supervision. The 12-month remediation period following the initial inspection report is key to the overall outcome of the inspection process.”*

The report comes in two parts: a public component and a private, undisclosed section. Several members said that they had discussed the private portion with their auditors and asked about improvement initiatives that the firm is undertaking both generally and in response to the PCAOB report.

Many members questioned the value of inspections. One shared this perspective on discussing the public and private portions of the PCAOB report with an audit partner: *“I didn’t find the [recommended] changes to be credible, and if in fact the changes were made, they [would have been] a complete waste of time.”* Furthermore, members doubt that the PCAOB’s proposed Auditing Standard No. 5 (AS5) will lower external audit fees, especially if the reports continue to focus on what members perceive to be low-value audit activities such as detailed audit documentation.

In a separate conversation, Mr. Olson said on this topic: *“There have been substantial improvements in audit quality since PCAOB inspections began in 2003; inspections have brought discipline to the process. PCAOB inspections are leading to improvements in the performance of audits, just as an audit adds value to a company’s financial reporting process.”*

### Improve oversight of executive compensation

Members and some guests condemned the recent stock option backdating scandals, but fear the fallout from new executive compensation disclosures. With all the regulatory and media attention being paid to executive compensation, one member referred to it as *“the new 404,”* saying, *“The media are waiting to feast on the disinformation that is going to come out with comparisons of overpaid CEOs. We are in for a year or so that will feel like 404 – too much attention, overdone, and it’s very sensitive as executive compensation is more interesting than accounting and internal controls. It’s another [potential] black eye for the U.S. capital markets.”*

#### Stock option backdating

Mr. Thain voiced an opinion commonly held by network members when he said he *“didn’t think that compensation committees, audit committees, or CEOs would have let this kind of thing happen.”* But now that the issue is front and center in the media and for regulators, members and some guests offered these suggestions for making sure that option backdating doesn’t further erode investor trust in capital markets:

- **Have a formal policy and process governing option grants, and test accordingly.** Mr. Hewitt commented on one step in fixing the process of option granting: *“Companies need a written policy on this, and the vast majority didn’t have one. The external auditors can test against the policy.”*
- **Take control over option grants away from CEOs.** Regarding management’s control of the option-granting process, Mr. Thain asked, *“What compensation committee thought it was a good idea*



*to delegate [option granting] to the CEO? Audit committees should not have let CEOs write options for other employees on their own.”*

- **Punish those responsible.** Mr. Hewitt’s opinion on the matter of option backdating couldn’t have been clearer: *“It is illegal.”* Members widely agreed that those who committed the crimes should be punished accordingly.
- **Don’t allow options to be priced at levels that would cause embarrassment if disclosed.** Mr. Thain asserted that *“you can price options at what you want as long as you disclose it and account for it properly.”* In short, boards shouldn’t allow pricing that would create embarrassment if fully disclosed. Transparency is essential.
- **Audit committees should ensure tone at the top addresses the issue.** Mr. Hewitt said, *“It is important to know what’s going on with tone at the top ... It is your job [as directors] to look at [it].”*

## New compensation disclosures

Members also discussed the challenges posed by required executive compensation disclosures such as the compensation discussion and analysis (CD&A).<sup>7</sup> The following suggestions emerged for making disclosures as clear as possible:

- **Improve communication with the marketplace.** One member stated, *“American business has just done a very bad job communicating these [executive compensation] issues.”* Perhaps communication has failed most significantly when it comes to explaining how executives earn their money: *“The troubling thing about the disclosures is that our CEOs get paid based on performance – how well the stock does versus the S&P 500, improving cash flow, etc. – but this is not clear at all in the proxies. This year’s calculation assumes performance that has not happened yet.”*
- **Don’t approve plans that can’t be comfortably explained to average investors.** Mr. Thain cautioned members against approving pay packages that are hard to explain: *“Whatever you want to pay your CEOs, you should be willing to disclose it. You should disclose it and defend it, not try to hide what’s going on.”*
- **Explore producing materials to supplement the CD&A.** Mr. Thain observed that *“if you look at the comp table required by the SEC, you can’t even tell how much an executive made.”* The NYSE Group’s solution involves a novel, voluntary disclosure: *“We’re actually doing our own [supplementary] table this year: it contains base salary, cash bonus, RSUs, value of options at grant date, change in value of post-retirement benefits, and value of any other benefits, totaled up into one number for the year. You just can’t find this number in the SEC table.”*

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<sup>7</sup> In 2006, the SEC changed executive compensation disclosure requirements to include the CD&A in the annual proxy statement to all shareholders. It is intended to be a plain English explanation of the objectives and implementation of the listee’s executive compensation plans. The CD&A is followed by the summary disclosure table, which contains cash values of executive compensation for the CEO, the CFO, and the three other highest-paid executives at the company. More information about the SEC’s required compensation disclosures can be found at <http://www.sec.gov/news/press/2006/2006-123.htm>.

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## Conclusion

Boards and audit committees need to address the Audit Committee Leadership Summit's four recommendations for enhancing trust and competition in global public capital markets. The dialogue has started, the conversation has been joined, and board directors, their auditors, and their regulators have opened the door to some fresh thinking about the U.S. public capital markets. As one European audit chair said at the meeting, *"I feel saddened about the state of the U.S. capital markets."* But that state can be improved if there is rationalization of the regulatory environment, simplification of accounting standards, strengthening of the public company accounting profession, and improvement in the oversight of executive compensation.

## About this document

The Audit Committee Leadership Networks in Europe and North America are groups of audit committee chairs drawn from leading global companies committed to improving the performance of audit committees and enhancing trust in financial markets. The networks are convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit 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 this document 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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