

Compensation, risk, and the role of the audit committee

Introduction

On October 22–23, 2009, members of the Audit Committee Leadership Network (ACLN) met to discuss risk management best practices¹ and the link between compensation and risk. This document² reflects a summary of the key points raised regarding compensation and risk, along with selected perspectives that members shared before and after the meeting. For further information about the network, see “About this document” on page 10. For a full list of participants, see Appendix 1 on page 11.

Executive summary

While the link between compensation policies and corporate performance has been discussed for years, the recent financial crisis has highlighted an aspect of the issue that the discussions have not always addressed directly: the ways in which compensation policies might motivate senior management or key employees to take excessive risks that could threaten the value of the company or even its survival. During their discussion of compensation and risk, members focused on the following topic areas:

- **The emergence of compensation-related risk as a key governance issue** (*Page 2*)

Risks associated with compensation have emerged as an important political issue driving new regulatory and legislative efforts, such as the Securities and Exchange Commission’s (SEC’s) proposal calling for more disclosure on how companies are addressing these risks. The outcome of these efforts remains unclear, and ACLN members are somewhat skeptical of their value and the emphasis on compensation-related risks over other risks. Nevertheless, members acknowledge that compensation can drive excessive risk taking and note that many large companies have long recognized the dilemma posed by certain types of sales incentives.

- **Assessing the link between compensation and risk** (*Page 4*)

Outside of financial services, many companies are only just beginning to focus in depth on how to assess compensation-related risks, turning to a number of criteria and metrics to determine when healthy risk taking crosses the line to become excessive. Members say that, on the whole, compensation consultants have not been at the forefront of intellectual leadership on this issue, but are evolving to better serve their clients.

- **The role of the board and the audit committee** (*Page 7*)

¹ See Audit Committee Leadership Network, “Leading risk management practices,” *ViewPoints*, November 30, 2009. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Nov09_View27.pdf.

² *ViewPoints* reflects the network’s use of a modified version of the Chatham House Rule whereby names of members and guests and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or corporations. Member quotes, from conversations held prior to the meeting as well as during the meeting, appear in italics.

Overseeing the assessment and disclosure of compensation-related risks is chiefly the role of the compensation committee and the full board, which has shown increasing interest in the issue over the past few years. At the same time, the audit committee can apply its expertise to assess key drivers of compensation, including data streams, triggers, and quality of earnings. It can also review the proxy statement, the compensation discussion and analysis (CD&A), and other disclosures. The external auditor can be a valuable source of expertise and guidance with this work.

Appendix 2 on page 12 includes a list of discussion questions for audit committees.

The emergence of compensation-related risk as a key governance issue

The financial crisis has seen many banks fail and others require rescue by the government. While multiple factors contributed to the crisis, many observers believe that the compensation policies at financial institutions played a major role by encouraging both executives and employees further down in the organization to take excessive risks that ultimately yielded disaster.³

This diagnosis explains why, in initiatives from the SEC, the Federal Reserve Board, the US Department of the Treasury, and Congress, compensation is an issue of major concern.⁴ While the focus of some of these initiatives is squarely on financial services, others target all public companies.

The SEC's proposal on disclosures

The prospects for some of the legislative efforts on Capitol Hill are unclear, but one initiative that seems likely to be implemented is the SEC's proposed rule on proxy disclosures regarding the links between compensation and risk, board leadership, and board oversight of risk management. The comment period for this proposed rule ended on September 15, 2009, and the SEC hopes to have a final rule in place by the 2010 proxy season, which means that companies will soon need to start acting on its directives.

In the area of compensation, the proposed rule enhances earlier requirements regarding what companies have to disclose about their compensation policies and practices. In 2007, companies were required to include a CD&A in the proxy statement. This requirement was intended to expand and improve the information that investors had on compensation, but it did not focus explicitly on the issue of risk. The current proposal amends the CD&A requirements "to broaden their scope to include a new section that will provide information about how the company's overall compensation policies for employees create incentives that can affect the company's risk and the management of that risk."⁵ A key point is that the disclosures apply not only to executives but to many other employees as well.

³ This was the conclusion of the Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (London: Financial Stability Forum, 2009). Available at http://www.financialstabilityboard.org/publications/r_0904b.pdf.

⁴ For example, the Shareholder Bill of Rights introduced by Senators Charles Schumer and Maria Cantwell, the Shareholder Empowerment Act introduced by Representative Gary Peters, the Compensation Fairness Act introduced by Representative Barney Frank, the US Treasury's Investor Protection Act of 2009, the Federal Reserve Board's proposed guidance on sound incentive compensation policies, and the Restoring American Financial Stability Act of 2009 introduced by Senator Christopher Dodd.

⁵ US Securities and Exchange Commission, "Proxy Disclosure and Solicitation Enhancements," proposed rule, July 10, 2009, 8. Available at <http://www.sec.gov/rules/proposed/2009/33-9052.pdf>.

Disclosures would be required only for risks that could have a material effect on the company, and the rule provides for flexibility regarding the specifics disclosed, acknowledging that what is relevant will vary from company to company. The rule offers guidance by pointing to a number of situations that could trigger disclosures, such as the existence of business units that carry “a significant portion of the company’s risk profile” or are “significantly more profitable than others within the company.”⁶ The rule also provides examples of the issues companies might have to address, which are paraphrased in the box below:

The SEC’s examples of compensation issues companies may need to address⁷

1. The general design philosophy of the company’s compensation policies
2. The company’s risk assessment or incentive considerations in structuring its compensation policies
3. How the company’s compensation policies affect both short- and long-term risks
4. The company’s policies on adjustments to its compensation to address changes in its risk profile
5. Material adjustments to compensation made as a result of changes in its risk profile
6. Company monitoring of compensation policies to ensure risk management objectives are being met

In its request for comments, the SEC solicited opinions on fundamentals such as whether the rule should even apply to companies outside the financial services industry. The comment letters received expressed a range of views. Some letters highlighted the difficulties of providing meaningful disclosures and the additional burden the effort would entail. Others, such as those from institutional investors, expressed strong support. Most network members said that their companies had not analyzed the SEC proposal closely, but their own general reactions were in line with the more skeptical comments submitted to the SEC. One member said, “*My view is this is likely to be a huge compliance exercise.*”

The eventual enactment of legislation that includes say-on-pay provisions will further heighten the importance of disclosures on the link between compensation policies and risk by giving to shareholders of non-Troubled Asset Relief Program (TARP) recipient companies an advisory vote on compensation. Given that an unfavorable vote might entail substantial reputation risk, companies will need to ensure that shareholders properly understand the disclosures.

⁶ Ibid., 9.

⁷ Ibid., 11.

Putting the issue of compensation-related risk in context

Members agreed that the link between compensation and risk is an issue that every company should consider. A member stated simply, *“Incentives matter a lot.”* One even went as far as to say, *“When something goes wrong, we find out it’s usually driven by comp.”*

At the same time, the risks associated with compensation policies are not always the most important risks, and some members believe the focus on them is at least partially media driven. One member remarked, *“I think this is a big to-do about nothing. It’s about headlines. For most companies, compensation risk is number five or six on the list of risks. It’s not nearly as important as other risks.”* Another member agreed: *“Tinkering with executive pay is totally beside the point.”*

Moreover, members noted that, in some respects, the issue is not really a new one. Large companies with far-flung subsidiaries or business units with a strong sales culture, for example, have always had to struggle with the fact that the culture in those subsidiaries can diverge in dangerous ways from the core culture, and that compensation-related factors can contribute to this divergence.

One member recalled how the incentive scheme at a sales-driven business unit unexpectedly created a culture clash: *“We had assumed the same ethics and culture applied. We didn’t realize these people would fudge things ... it wasn’t just one person, but a culture that was offensive to our ethics. We sent people there, and it took a while to straighten it out.”* Another member pointed to the importance of tailoring control mechanisms to the specific unit: *“One can’t assume all people will respond to the same policy in the same way. Those that ‘eat what they kill’ need different oversight.”*

A member shared an example involving an acquisition: *“Several people [in the new subsidiary] can make a lot of money selling [the product]. Our existing business people don’t make the same [amount] – even the sales people don’t. Our strategy is to keep them separate. It’s a cultural dilemma.”* Other members were skeptical that the sales-driven culture can be separate, particularly if sales teams have to work with each other to create value for customers: *“To say you are going to separate them but have cross-selling is impossible.”*

Assessing the link between compensation and risk

How will companies evaluate how their compensation practices affect risk? How will they use these evaluations to meet disclosure requirements? Despite the general awareness of the issue, not many companies and boards have clear answers to these questions yet. Some work has been done in the financial sector, where TARP participants are required to make certain disclosures. Among non-financial companies, however, even CD&A statements that contain extensive information about compensation levels and policies often say little about the links to risk.

One member noted, *“My companies need to come to grips with this. The next proxy season will be very revealing. I have no best practices to offer now.”* Another member agreed: *“In these discussions on my board where I’m on the compensation committee, I don’t recall the word ‘risk’ ever coming up.”*

Tools and challenges

Nevertheless, both the escalating debate on compensation and risk and some companies' early attempts to address the issue are beginning to reveal potential tools that management and boards might use to clarify the links between compensation policies and risk. These tools include metrics that quantify certain aspects of the issue as well as qualitative means of characterizing companies' compensation policies and practices in ways that relate to risk. They can be culled from recent reports by consulting firms and policy groups, statements by regulatory agencies, and even the CD&A statements of leading firms, particularly in the financial services industry. The box overleaf lists some examples.

At the meeting in New York, members discussed approaches to compensation and the challenges of managing the links between compensation and risk across large companies. One member noted, *"A very basic structure of compensation plans is that they influence risk. With options, a behavior develops which focuses on the upside, not the downside. Too much specificity in formulas leads to gaming."* Another member mentioned the importance of the data driving compensation: *"It's not just the compensation plan, but the performance metrics. You need the right components."*

Examples of metrics and evaluation criteria for assessing compensation-related risk⁸

- The percentage of compensation that is based on performance: a higher percentage represents a potentially stronger incentive to take risks.
- The materiality of compensation payouts: payouts that constitute a large percentage of the company's revenue constitute a risk that should be counterbalanced.
- The number and type of performance measures used to determine compensation: a higher number and diversity of measures may be less likely to distort behavior.
- The care with which the accuracy of performance measures is checked: performance measures need to be audited for accuracy, especially if they rely on internal numbers that are not audited in the course of standard financial reporting.
- The extent to which long-term performance is rewarded: provisions such as stock ownership and retention requirements, deferred bonuses, and clawbacks can help align the time horizon of risks and rewards. Focusing on the quality of earnings also helps.
- The degree of discretion in determining payouts: an avoidance of formulaic approaches in favor of flexibility provides recourse on payouts as conditions change.

⁸ Sources include the Financial Stability Forum, *FSF Principles for Sound Compensation Practices*; the Conference Board, *The Conference Board Task Force on Executive Compensation* (New York: The Conference Board, 2009), available at <http://www.conference-board.org/ectf>; Susan O'Donnell and Laura Hanf, *Risky Business: Assessing and Addressing Executive Compensation Risk* (New York: Pearl Meyer and Partners, 2009), available at <http://www.pearlmeier.com/knowledgecenter/articles/pdf/SO-LH-RiskyBusiness.pdf>; US Department of the Treasury, "Statement by Treasury Secretary Tim Geithner on Compensation," press release, June 10, 2009, available at <http://www.ustreas.gov/press/releases/tg163.htm>; and the 2009 CD&A statements of JPMorgan Chase, Goldman Sachs, Bank of America, and General Electric.

- The extent to which employee evaluations take into account the employee's risk management practices: rewarding specific practices (as well as outcomes) encourages better risk management and strengthens a culture of risk awareness.
- The extent to which certain risky pay practices are avoided: golden parachutes, golden coffins, guaranteed bonuses, and the like may only be justifiable under certain circumstances.

Members highlighted the fact that achieving business success inevitably entails risk taking. Managing risk cannot mean eliminating risk, so a balance must be struck: *"We had a lot of discussion at my company that we want to encourage management and [staff] to take certain risks. But what if they take a bet and are wrong? Do you fire them? Or assume they learned the hard way? Or demote them? Does this then act as a disincentive to stop others from taking risks? If you punish someone for taking a risk that doesn't pan out, you end up with mediocrity."*

One member noted that an optimal plan was difficult to achieve: *"No matter where people are in the business, they need to understand the business model and what drives growth and profitability. And you need to decide where to compensate them, but no plan is perfect. What are the systems to deal with it? You need to have good governance and compliance systems."*

Using compensation consultants

Discussion of the use of compensation consultants brought forth diverging perspectives from members. Some members described positive experiences engaging consultants to assess the risks associated with compensation plans (see the box below for two examples).



Using consultants to assess compensation and risk at two non-financial companies

The danger of “cliffs” in stock incentive schemes

The management at a large, global company worked with their compensation consultant to analyze the potential risks in their compensation programs. They approached the issue by asking, if a person in a particular role were venal and greedy, would the incentives they faced lead them to take actions that were not in the company’s best interests?

Applying this approach across the company, they discovered that one aspect of the compensation plan for top executives did in fact present an unanticipated risk. Executives had “cliffs” in their stock incentive scheme: if the price of the stock dropped below a certain threshold, the payout dropped to zero. By creating a very strong incentive to prevent the stock from going below that threshold, this feature of the plan created a temptation to manage earnings.

When this finding was reported to the compensation committee, the committee changed the stock incentive scheme. The committee is now considering deeper dives into the compensation program that will include the company’s risk management team as well as the audit committee.

continued on overleaf

Using consultants to assess compensation and risk at two non-financial companies *continued*

Avoiding early payouts

The compensation committee at a global company asked a compensation consultant to review the risks associated with its compensation schemes. The committee asked the consultant, a small, boutique firm, to disregard the practices at other companies: “We don’t care what other companies are doing; we only want you to pay attention to and discuss our business.”

The consultant found that the company’s compensation scheme was not driving excess risk. Nevertheless, it recommended certain improvements in the way stock options would vest, suggesting longer-term vesting that would conform more closely to the company’s business model.

Also, the consultant recommended that the way in which business deals were pursued and closed should be structured so that the staff would not get their entire payout immediately.

Nevertheless, compensation consultants also received some criticism at the meeting. One member remarked on the undifferentiated approach that consultants sometimes use: “*The problem today is that comp experts go back and do the same analysis [for all their clients], so all the programs look the same. We need to look at what drives the business. A lot of what I’ve seen is cookie-cutter.*” Another member noted, “*With consultants, it’s just a mathematical*

exercise on what others did.” One summed up a common view of consultants: “Compensation consultants are not going away, but they need to get better – be more progressive, be one to two years ahead.”

The role of the board and the audit committee

What will be the role of the audit committee in assessing and disclosing the link between compensation and risk? Company management, of course, conducts the assessment and produces the CD&A. On the board, the compensation committee traditionally takes the lead on compensation, determining compensation for the top executives, but also reviewing the compensation policies for other employees as needed. It also reviews and affirms the disclosures the company makes regarding compensation.

At the same time, the full board is beginning to take a stronger interest in compensation. One member noted, *“The board in general has more interest in compensation now than in the past.”* Another member echoed the point: *“I see the board having more interest in key aspects of executive compensation.”*

As boards struggle to meet the escalating demands being placed on them, the role of the audit committee in assisting the board and the compensation committee has become a topic of discussion. Of interest are not only the general ways in which the audit committee can contribute to oversight of compensation, including the practical ways in which the audit and compensation committees can work together, but also the role of the audit committee in addressing the specific issue of compensation and risk.

Audit committee tasks

Members mentioned specific tasks that audit committees should undertake as part of their role in overseeing compensation, some of which could involve the external and internal auditor. Many of these tasks stem from activities traditionally performed by the audit committee:

- **Reviewing the data stream.** The audit committee’s expertise in accounting and internal controls should be applied to the data used in compensation plans to determine payouts.
- **Checking triggers.** In addition to vetting the data that triggers payouts, the audit committee should evaluate the triggers and the behaviors they might encourage. One member noted, *“Our audit committee approves the compensation plan. We ask, ‘Does this goal make sense, or not?’”*
- **Assessing the quality of earnings.** The audit committee should make sure that the earnings numbers that are driving compensation reflect the company’s true earnings.
- **Reviewing the proxy and the CD&A.** The audit committee should assist the compensation committee in making sure that the numbers and explanations are accurate, clear, and consistent with other disclosures. As one member put, *“There are so many numbers in the CD&A. It would be embarrassing to get this wrong.”*

The external and internal auditor can assist the audit committee and the board in assessing and mitigating the risks associated with compensation. For example, as one member noted, the audit committee can *“ask the external auditor to check the calculations in the CD&A. We do this and test for understatements and overstatements.”* Another member described how the external auditor is involved in the development of the compensation



plan: *“We work with the external auditor and management to get together the raw material for the compensation plan.”* Members would like to understand the external auditor’s assessment of the company’s risks and the auditor’s perspective on potential cultural red flags, such as business units that are uncooperative with the internal or external auditors.

Improving cooperation on the board

Members warned that the audit committee should be careful to manage its workload and work closely with the compensation committee. As one member put it, *“You need communication between the two committees. But [if the audit committee takes on too much,] soon you may not need a board anymore – you’ll just need an audit committee. We don’t need to take on more [work].”* Another member noted, *“The compensation committee has to work closely with audit, and we are doing this more without overlapping.”*

At the February 2009 joint session of the ACLN and the Compensation Committee Leadership Network (CCLN), participants explored ways in which general cooperation between both the committees and the full

board could be improved.⁹ Members arrived at a number of suggestions, several of which were mentioned again at the October 2009 meeting (see box below).

ACLN/CCLN suggestions for improving board cooperation on compensation

- Greater communication between committee chairs
- Scheduling executive sessions on compensation at a time when they won't be rushed
- Cross-committee membership
- Special education sessions on compensation for non-compensation-committee board members
- Joint meetings and/or open invitations to committee meetings
- Sharing of all committee reports with every director

Conclusion

Regardless of how much compensation practices have actually spurred excessive risk taking, particularly in non-financial industries, the link between compensation and risk is currently a prime concern of governments, shareholders, and the broader public. Companies and boards will need to review their approaches to the issue and consider what they will disclose about it, using an array of metrics and indicators. Compensation consultants may be helpful, but only if properly directed. While oversight of the issue is ultimately the responsibility of the full board and the compensation committee, the audit committee should work closely with them to review the metrics that drive compensation, the quality of the data used by the compensation committee, and the related disclosures. The external auditor may be helpful in this regard.

⁹ Audit Committee Leadership Network, "Joint considerations for audit and compensation committees," *ViewPoints*, March 5, 2009, 5-7. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Mar09_View26.pdf.



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.

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Appendix 1: Participants

Audit Committee Leadership Network members participating in all or part of the meeting, who sit on the boards of about 25 large, mid-, and small-cap public companies between them, included:

- Denny Beresford, Audit Committee Chair, Kimberly-Clark
- Dick Harrington, Audit Committee Chair, Xerox
- Labe Jackson, Audit Committee Chair, JPMorgan Chase
- Mike Losh, Audit Committee Chair, TRW Automotive
- George Muñoz, Audit Committee Chair, Altria and Marriott International
- Chuck Noski, Audit Committee Chair, Microsoft and Morgan Stanley
- Peter Ueberroth, Audit Committee Chair, The Coca-Cola Company
- Sandy Warner, Audit Committee Chair, General Electric Company
- Steve West, Audit Committee Chair, Cisco Systems
- Chris Williams, Audit Committee Chair, Wal-Mart

Ernst & Young partners participating in the meeting included:

- Tom Hough, Americas Vice Chair of Assurance Services
- Steve Howe, Americas Managing Partner



Appendix 2: Questions for audit committees

- ? Is the link between compensation and risk a real concern for companies outside the financial services industry?
- ? What are your companies' views on the SEC's proposed rule? Will it have significant implications?
- ? What metrics and criteria do you think could be helpful in assessing the link between compensation and risk? What implementation challenges worry you the most?
- ? What kind of tools and processes are risk management teams and compensation consultants developing to assess risk? How can compensation consultants add value to the process?
- ? What specific tasks can the audit committee perform to assist the compensation committee and the full board in their oversight of compensation risk? What role can the external auditor play?
- ? What are best practices for achieving effective cooperation between the audit and compensation committees?