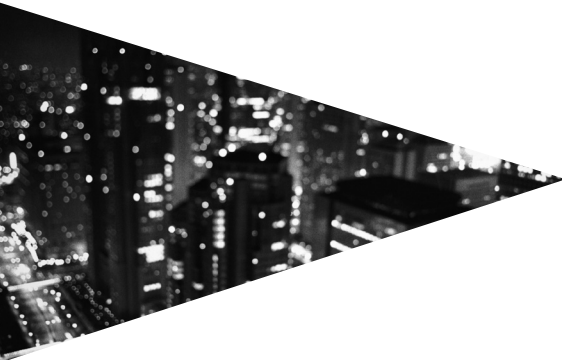


Four specific roles for audit committees in remuneration oversight



“The board as a whole is responsible for pay, but there has to be interplay between the committees who advise the board. The remuneration committee has primary responsibility, but it has to work with the other committees, including the audit committee, that are looking at major risks in the company and the company strategy.” *Investor*

Executive summary

Audit committees have not traditionally played an active role in remuneration oversight. But there are signs that this might change in future. With executive compensation becoming a key area of reputational risk for companies, boards are paying closer attention to pay practices. For audit committees, there are now four specific areas where they can be involved as an advisor to the main board:

- ▶ Ensuring links between pay and risk are understood
- ▶ Helping to link pay plans with the company’s strategic goals
- ▶ Providing insight into complex metric and accounting issues
- ▶ Taking a broader review of remuneration disclosures

These are the key findings of research commissioned by Ernst & Young among audit committee chairs, board directors, investors, regulators, audit executives, academics and other subject matter professionals across Europe. The research, undertaken by Tapestry Networks, set out to determine how leading audit committees are currently engaging in oversight of remuneration. Other key findings include the following:

Remuneration risk has been elevated on the governance agenda. Executive compensation has long been a key topic for discussion with investors but companies must now take a broader range of stakeholders into account. Regulators, in particular, have surpassed investors in driving reform of remuneration plans and disclosure, which creates its own risks for companies. Meanwhile, media coverage of pay packages has become a key source of reputational risk. This intense scrutiny and heightened risk has elevated remuneration to the top of the governance agenda and it is now often a matter for the full board.

Increased scrutiny and risk have led to specific audit committee roles in remuneration oversight. While the remuneration committee continues to be the primary oversight body, audit committee members can also play a prominent role. Their accounting and financial expertise means that they can help their boards to understand the linkages between pay and risk and ensure that performance metrics are aligned with the strategic goals of the company. Audit committees can also validate pay metrics and ensure that messages to the market are valid and consistent.

The role of the audit committee in remuneration oversight could become more formal over time. Although the role of audit committee in remuneration is not formalized, boards are ensuring that there are connections in place between audit and remuneration committees. This might include overlapping committee membership between the two or close partnership and cooperation between committee chairs. Over time, we may see audit committees playing a more formal role in remuneration oversight as regulators continue to seek ways to improve corporate governance in Europe.

Remuneration risk has been elevated on the governance agenda

Once, it was mainly investors who placed pressure on companies to justify or explain their compensation plans. But ever since the financial crisis placed executive remuneration firmly on the public radar, companies are now finding that they face scrutiny from a much broader set of stakeholders. Today, it is regulators and the public - fueled by sensational media coverage - that are the driving force behind much of the momentum for change.

Regulators have become the new driver of remuneration reform

In their eagerness to address the root causes of the financial crisis, the European Commission and other regulators are paying careful attention to the structure of pay and the disclosure of pay practices. One investor questioned for this report said that many investor groups see this as a positive development. "A lot of what is happening now is what shareholders have wanted all along," he explained. "What the regulators are doing is bringing it faster." But not all interviewees share this view. Some argue that regulators have already gone too far. "The largest investors are worried that too much attention is being placed on pay to the detriment of other subjects like risk oversight and company strategy," said one research participant.

In their drive to reform, regulators are making a clear distinction between financial and non-financial sectors:

► Financial services companies are bearing the brunt of regulatory change ...

The financial crisis prompted accusations that banks provided "substantial awards to executives and employees for meeting short-term goals without adequately recognizing the possible impact on the bank's risk profile."¹ In an attempt to address these failings, bodies such as the G20 and the Financial Stability Board (FSB), which develops and implements policies in the interest of financial stability, have recommended a number of changes to pay in the industry. In 2009, for example, the *FSB Principles on Sound Compensation Practices* recommended that financial institutions re-design remuneration plans to ensure that pay is aligned with risk and company financial performance. It also suggested that a "significant portion" of variable pay be deferred for a number of years.²

¹ Moody's, "Bank Compensation Reform, Short term improvements, Long-term Questions," 9 March 2011.

² Financial Stability Board, "FSB Principals on Sound Compensation Practices," 2 April 2009.

³ European Commission, "Commission Recommendation," April 2009.

► ... but pressure for reform is spilling over to other sectors

Some research participants note that change in the financial services sector has challenged the framework of pay. Over time, some expect that this will give shareholders a platform to push for change in other sectors. The European Commission has also taken up the issue. In 2009, it issued a recommendation on the remuneration of directors of listed companies. This suggested that companies should provide shareholders with a vote on remuneration policy and select performance criteria that promote the long-term sustainability of the company.³ In addition, the Commission's most recent green paper, *The EU Corporate Governance Framework*, recognized a mismatch between performance and executive directors' remuneration and questioned whether to legislate pay disclosures and a shareholder vote on remuneration policies.⁴ Meanwhile, research participants from non-financial companies indicate that their organizations are also making changes to their pay practices, such as adopting better key performance indicators and developing a longer-term view of the world.

Emerging trends in pay

Some companies are making significant changes to their remuneration plans. Key trends include:

- **Incorporation of non-financial metrics in short-term schemes.** Companies are increasingly using non-financial metrics, such as health and safety or product quality measures, as a component of their performance pay. Investors are supportive of this and are showing "a growing interest in the use of non-financial metrics as part of the performance criteria."⁵
- **Emphasis on sustainable performance metrics.** Many companies are re-evaluating remuneration plan metrics to ensure they deliver value both to the company and the executive over the long term. Companies are using a variety of metrics to achieve this, which are both challenging and linked with long-term goals. Examples include total shareholder return (TSR) vs. peer group, earnings per share (EPS) growth vs. peers, return on capital targets, TSR targets and cash flow targets.⁶
- **Lengthening the time horizon for long-term performance metrics.** Moving to longer time horizons increases the alignment between management and long-term shareholders. "Companies are moving away from the three-year long-term measure," explained one investor. "They want longer [time horizons], so they are moving toward five years or more."

⁴ European Commission, "The EU Corporate Governance Framework," April 2011.

⁵ HQB Partners, "Pre-AGM Season Investor Survey 2011," March 2011.

⁶ Ibid.

“The moment that the remuneration package has an impact on the reputation of the company, the audit committee has to look at it.” *Audit advisor*

Public interest and media coverage of pay has intensified reputational risk

Over the past three years, executive remuneration has received significant coverage in the business and mainstream media. Press stories about pay packages at failing financial institutions led to public outrage toward perceived “fat cats.” This “media interest in excess” has created new sources of reputational risk for companies.

The public dialogue around compensation has become more sophisticated and expanded beyond the financial services sector. “Remuneration is no longer a private matter between a company and its investors,” noted one media expert. “It’s much more political.” Indeed, it can become a major reputational issue. “If you have a crisis and there is a sense of injustice about your pay ... [then] you are in big trouble,” noted one research participant.

Proxy advisors, who present voting recommendations to investors on proposals at company shareholder meetings, can heighten the potential for backlash and headline-grabbing attention about company pay practices. Some proxy advisors employ forensic accounting teams that are on the look-out for accounting tricks that could be associated with compensation payouts.

An “against” recommendation has a powerful effect on the media, investors and the general public. Earlier this year, for example, shareholders of Novartis narrowly approved the remuneration plan presented at the annual meeting, after it garnered “against” recommendations from major proxy advisors and investor groups.⁷ As shareholder votes on remuneration become more common throughout Europe (see table below), remuneration plans that do not meet standards set by regulators and investors will create risk for companies.

The European Commission finds member states are adopting “say on pay” voting and long-term performance criteria in pay plans across the EU

Table 1 below indicates the extent to which select member states have adopted two of the European Commission’s 2009 recommendations on remuneration: 1) providing a shareholder vote on remuneration and 2) subjecting variable remuneration components to pre-determined and measurable performance criteria that promote the long-term sustainability of the company and include non-financial criteria.

Table 1

Market	Vote on remuneration? ⁸	Performance criteria in variable remuneration? ⁹
UK	Yes, advisory vote	Partially, no recommendation on inclusion of non-financial performance criteria
The Netherlands	Yes, binding vote	Yes
France	Yes, binding vote, included in the vote on the annual report	Partially, performance criteria are not explicitly predetermined and measurable and they are linked to the medium term
Italy	No	Yes
Sweden	Yes, binding vote	Partially, no recommendation on inclusion of non-financial performance criteria
Germany	Yes, advisory vote	Partially, no recommendation on inclusion of non-financial performance criteria

⁷ Goran Mijuk, “Novartis payouts irk some investors,” *Wall Street Journal*, 22 February 2011.

⁹ Financial Stability Board, “Thematic Review on Compensation,” 30 March 2010.

⁸ European Commission, “Report on the application by Member States of the EU Commission 2009/385/EC Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies,” 2 June 2010.

Remuneration risk has been elevated on the governance agenda *continued*

As remuneration risk increases, so too does board oversight

Regulatory focus and media attention on pay mean that remuneration risk (the risk that pay plans reward executives incorrectly or unethically, causing significant reputational damage) is at an all-time high. As a result, boards have been challenged to reconsider their oversight practices. "There has certainly been a change in the full board discussion [on remuneration]," noted one audit chair.

Board-level discussions about remuneration have become more detailed and frequent and aim to draw upon the full suite of skills on the board. This new focus is starting to have an impact. In March 2010, the FSB's *Thematic Review of Compensation* found that "greater progress has been achieved in the areas of governance, establishing supervisory oversight and promoting disclosure of compensation."¹⁰

Some leading companies have instituted educational programs for board directors to ensure that they understand the complexities of the remuneration plans and are fully prepared to discuss them at board level. One audit chair noted that a recent session included themes such as "How remuneration levels are calculated, how the [remuneration committee] sets long-term and short-term objectives ... and how values are linked to those objectives."

However, increased involvement by the full board in overseeing remuneration has not taken away responsibilities from the remuneration committee. Research participants agreed that remuneration committees still remain the primary oversight body and are responsible for making recommendations to the board. Indeed, the increased scrutiny on pay has prompted remuneration committees to spend more time ensuring that their plans appropriately award pay for performance.

Increased scrutiny and risk have led to specific audit committee roles in remuneration oversight

Research participants agreed that audit committees have an important, yet limited, role in remuneration oversight. Whether weighing in during full board discussions on pay, or during audit committee discussions on pay-related risks, the financial expertise found within the audit committee is becoming increasingly important in some key areas of remuneration.

Participants said audit committees can:

1. Ensure links between pay and risk are understood
2. Help link pay plans to the company's strategic goals
3. Provide insight into complex metric and accounting issues
4. Take a broader review of remuneration disclosures

1. Audit committees can ensure links between pay and risk are understood

Regulators are seeking to ensure that board members with responsibility for risk oversight address remuneration risk. For example, the FSB's *Principles on Sound Compensation Practices* stipulate that the remuneration committee should "work closely with the firm's risk committee in the evaluation of the incentives created by the compensation system."¹¹ Outside the financial services sector, where risk committees are less common, the audit committee often owns risk oversight. Remuneration risk should also be included in any holistic enterprise risk management (ERM) analysis. "Audit committees should spend time understanding where compensation-related risks fit into enterprise risk management," noted one research participant.

Audit committees can play a critical role in creating a link between risk and pay and ensuring that this is understood at board level. They can achieve this by:

- ▶ **Applying skepticism to remuneration risk assessments.** Some boards are spending more time exploring how a plan or metrics could create risk for the company. One audit chair said there is new board-level focus on "unintended consequences of pay." Audit committees are well positioned to understand and highlight how some metrics might create pay risk. For example, they can assess how EPS performance calculations will be affected by a share repurchase.
- ▶ **Helping boards and remuneration committees think of remuneration risk in the context of the company's overall risk profile.** Investors and regulators are pushing companies to understand and articulate how pay practices influence the overall level of risk. With many audit committees expanding their oversight of risk,¹² they are in a strong position to push management to make more in-depth analyses and bring issues to the attention of the remuneration committee. For example, some companies have small sales or trading operations in which a select few employees may be incentivized for behavior that dramatically increases the overall risk profile.

¹⁰ Financial Stability Board, "Thematic Review on Compensation," 30 March 2010.

¹¹ Financial Stability Board, "FSB Principals for Sound Compensation Practices," 25 September 2010.

¹² Ernst & Young, "Doing more and doing it better: audit committees meet today's demands," April 2011.

“The audit committee should ensure the remuneration targets are challenging and the performance of the company and the state of the company is reflected in the payout.” *Investor*

- ▶ **Elevating latent risks to the remuneration committee and full board.** Audit committee members should be aware of how accounting changes might affect remuneration incentives as part of their review of enterprise risk. For example, changes in revenue recognition policies or inventory accounting could affect performance metrics that are part of a remuneration plan, such as operating margin growth or net income growth. In these instances, said one participant, the audit committee should raise the issue with the remuneration committee to ensure that they have discussed whether it could expose the company to additional risk.

2. Audit committees can help link pay plans to the company's strategic goals

Regulators and investors are looking for pay plans that incentivize management in a way that is aligned with shareholder value creation. As one research participant noted, “[large institutional investors] simply want to see that the remuneration policy is aligned with company performance ... that’s all they want.”

Audit committee members are well suited to ensure that this alignment is in place because they understand the linkages between the financials and the strategic goals of the company. Participants pointed to two key activities audit committees undertake to promote better alignment:

- ▶ **Advise on metric design.** The remuneration committee will often work with remuneration consultants to design metrics for the remuneration plan, but some committees are involving the audit committee in the metric selection process. The audit committee has deep knowledge of the financial metrics used to measure progress toward the company's strategic goals. As such, members can advise the remuneration committee on the incentive metrics that would be most closely aligned with the long-term goals of the company.
- ▶ **Assess targets.** Audit committees also have a deep understanding of the financial information used to determine the appropriate target levels for each of the metrics. This means that they can better assess whether target levels would be a stretch or easily attainable. As one audit committee chair explained, “We make sure the audit committee has approved the financial targets [for the remuneration plan].”



Remuneration risk has been elevated on the governance agenda *continued*



3. Audit committees can provide insight into complex metric and accounting issues

The increasing complexity of remuneration plan structures, performance metrics, and vehicles for delivery of awards (such as stock options and grants) has made the audit committee's financial expertise a vital asset for remuneration committees.

Research participants outlined several areas where audit committees can help:

- ▶ **Advising how corporate events could impact remuneration plans and incentive payouts.** Mergers, acquisitions and corporate restructuring activities have a significant impact on financial statements. In turn, they are also likely to impact the performance metrics included in the remuneration plan. Participants suggest that the audit committee should collaborate with the remuneration committee to ensure they understand the full impact of the event on the remuneration metrics.
- ▶ **Challenging the validity of existing metrics.** Audit committees can advise the remuneration committee if there are weaknesses in pay plans. Examples might include scenarios where metrics could be manipulated, either deliberately or inadvertently.
- ▶ **Ensuring appropriate accounting for metrics.** Participants suggested that audit committee expertise is very important in reviewing a company's accounting policies to ensure they are not manipulated to achieve certain performance targets. One investor suggested audit committees could have a role in ensuring that "the company has adequately applied performance metrics and that management has not played around with the numbers." And, in cases where the remuneration committee has instituted a new metric, the audit committee could "follow the metric ... to ensure performance [is] due to management action, not some outside factor."
- ▶ **Performing scenario tests on new remuneration plans.** Before companies issue new pay plans, audit committees can work with the remuneration committee to calculate simulations of certain events. This helps to ensure the plans are fair and long-term focused. For example, audit committees might help determine how remuneration payouts would be affected by outside factors such as generic market growth.

“The remuneration committee makes sure the audit committee has approved the financial targets for the remuneration plan.” *Audit Committee Chair*

- ▶ **Reconciling year-end financial metrics for remuneration purposes.** At the end of the year, a company may have events included in the financial statements that were out of management control and therefore should not be included in their performance assessment. The audit committee is well placed to offer advice on whether to include or exclude some non-recurring items on the income statement that could affect performance payouts. “This [reconciliation] has always been part of the remuneration process, but it’s happening more precisely and more rigorously than it has in the past,” noted one remuneration adviser.
- ▶ **Validating relative measures.** Some remuneration committees are calling on the expertise of the audit committee to ensure that relative measures are calculated correctly. “If we are comparing [our] net income per [unit] with [our competitor’s], we sometimes need to adjust financial results to get an apples to apples comparison - that is a financial issue that the audit committee is involved in,” explained one remuneration committee chair.

Leveraging audit advisors to dig into the numbers

To provide the support to remuneration committees identified by research participants, audit committees can leverage the expertise of:

- ▶ **Internal audit.** The growing complexity of remuneration plans highlights the importance of involving internal audit to ensure that metrics are accounted for accurately. Indeed, a recent survey of European HR and remuneration executives at financial services companies indicated there is interest in having “control functions ... involved in validating, aligning or assuring quality target setting.”¹³ Some internal audit teams are also involved in scenario testing, where they are asked to review management’s incentives to identify how they might be manipulated.
- ▶ **External audit.** Some companies use the external auditor to verify performance targets. As one audit chair explained, “When we get to the point in the year when the compensation committee needs to agree on an annual bonus associated with whether people have exceeded or met targets, we’ll make sure the targets are ones that the audit committee has approved, but really it’s the external auditor that does that check. If we need to [modify financials to make a comparison] we will outsource that to [our external auditor].”

4. Audit committees can take a broader review of remuneration disclosures

Regulators and investors have emerged from the crisis with a new drive to ensure that companies disclose not only the quantum of executive pay, but also the rationale for the approach they have taken. The European Commission’s recent green paper on corporate governance questions whether companies should be required to disclose the remuneration policy as well as the individual remuneration of executive and non-executive directors.”¹⁴

With so much attention focused on the information disclosed in remuneration reports, audit committees are beginning to widen their oversight of disclosure reviews. Research participants suggested that this would bring two key benefits:

- ▶ **Audit committees can help to ensure consistency across company statements that discuss financial metrics.** To avoid communicating conflicting information to the market, some leading audit committees have begun reviewing the financial information in the remuneration report to ensure that it is consistent with the information in the broader financial statements. “The audit committee will look at the remuneration disclosure where it could have an effect on the financial statements,” explained one audit advisor. “They should review the remuneration paragraph where the metrics are included. It might provide a [target percentage] of share price improvement over competitors. The moment you write that into your financial statements, you need to make sure the information is refuted and audited in some way by the audit committee.”
- ▶ **Audit committees could help to promote more clarity in remuneration reports.** Participants agree that regulatory proposals are leading to increased levels of disclosure but it’s an iterative process that can take time. After the legal requirement is imposed, there is a long period of evolution. Investors are largely supportive of the regulatory reform aimed at enhancing disclosure but some indicated that disclosure “still has a way to go.” As one investor said, “We don’t need more information; we need simpler disclosure that is easier to understand.” Similarly, the Financial Times’ Lucy Kellaway recently wrote that the “obfuscating detail” in remuneration reports is not making disclosure better; it’s “having the opposite effect.”¹⁵

Pressure to improve the clarity of remuneration reports is intensifying and this creates risk for companies. PIRC, a proxy advisory firm, recently recommended against a remuneration report because the company’s system of setting pay was too complicated.¹⁶ While improving the legibility of remuneration reports will likely be the responsibility of the remuneration committee, the audit committee may become a driving force behind more rapid improvement in remuneration disclosure if it starts presenting risk to the company, such as through proxy advisor criticism.

¹³ Mercer, “Executive Remuneration in financial services: a moving target,” 3 November 2010.

¹⁴ European Commission, “The EU Corporate Governance Framework,” April 2011.

¹⁵ Lucy Kellaway, “Drivel is in the detail with CEO pay,” *Financial Times*, 17 April 2011.

¹⁶ Ibid.

Remuneration risk has been elevated on the governance agenda *continued*

Table 2: European state regulators are encouraging more disclosure

Remuneration disclosures are improving; however, the rate of improvement differs, creating significant variation across member states. The table below captures key disclosure requirements, as indicated in the corporate governance codes of select member states.

	UK ¹⁷	Netherlands ¹⁸	France ¹⁹
Remuneration report	<ul style="list-style-type: none"> Policy for current and subsequent years Relative importance of each element of remuneration Explains which elements are not linked to performance 	<ul style="list-style-type: none"> Policy for current and following year How the remuneration policy contributes to the achievement of the long-term objectives of the company in keeping with the risk profile 	<ul style="list-style-type: none"> Principles and reasoning of the remuneration policy Tabular summary of all compensation commitments for the year under review, as well as for the two previous years, broken down into short-, medium- and long-term compensation
Individual pay disclosure	<ul style="list-style-type: none"> Yes, comply or explain 	<ul style="list-style-type: none"> Yes, comply or explain 	<ul style="list-style-type: none"> Yes, legislated
Variable pay and performance metrics	<ul style="list-style-type: none"> Performance conditions for shares and long-term incentives Why the performance conditions were chosen Assessment of performance metrics to determine if conditions were met 	<ul style="list-style-type: none"> Value and number of shares, options on the date of granting Status of shares and options (conditional or unconditional and when the vesting period and/or lock-up period ends) Discretionary components of the variable remuneration Description of the performance criteria for variable pay The relationship between performance criteria and strategic objectives Relationship between remuneration and performance 	<ul style="list-style-type: none"> Relationship between compensation, performance, and performance objectives Criteria used in the variable portion of compensation If the executive directors' personal objectives were achieved Weighting of each criterion in the discretionary compensation calculation, as well as the year-to-year variation
Relative measures	<ul style="list-style-type: none"> Peer groups used to determine performance Graph illustrating company's TSR vs. broader market index 	<ul style="list-style-type: none"> Composition of the peer group 	<ul style="list-style-type: none"> None
Special arrangements	<ul style="list-style-type: none"> Termination payments Employment contracts 	<ul style="list-style-type: none"> Contracts with management Severance pay or other special remuneration and related risks 	<ul style="list-style-type: none"> Amount, circumstances and motives for special compensation
	Italy ²⁰	Sweden ²¹	Germany ²²
Remuneration report	<ul style="list-style-type: none"> The reasons and criteria on which remuneration is based 	<ul style="list-style-type: none"> Clear and simple explanation for the reasons for the scheme Principal conditions of the scheme 	<ul style="list-style-type: none"> Total compensation of the members of the management board Information on the nature of the fringe benefits
Individual pay disclosure	<ul style="list-style-type: none"> Yes, legislated 	<ul style="list-style-type: none"> Yes, legislated 	<ul style="list-style-type: none"> Yes, legislated
Variable pay and performance metrics	<ul style="list-style-type: none"> Details of the relative importance of the fixed and variable components (including performance-linked bonuses and equity-based remuneration) 	<ul style="list-style-type: none"> Any dilution of the share capital that may result from the scheme Total cost to the company of different conceivable outcomes 	<ul style="list-style-type: none"> Fixed and variable compensation components
Special arrangements	<ul style="list-style-type: none"> Termination payments 	<ul style="list-style-type: none"> None 	<ul style="list-style-type: none"> Termination benefits
Important note	<ul style="list-style-type: none"> None 	<ul style="list-style-type: none"> None 	<ul style="list-style-type: none"> Three-quarters of the general meeting may resolve disclosure is not necessary

¹⁷ "The Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008," 19 February 2008.

¹⁸ The Dutch Corporate Governance Code, 10 December 2008.

¹⁹ Association française de la gestion financière, "Recommendations on corporate governance," January 2010.

²⁰ Supervisory Provisions Concerning Banks' Organization and Corporate Governance, page 14, 4 March 2008.

²¹ Swedish Corporate Governance Board, "The Swedish Corporate Governance Code," 1 February 2010.

²² German Corporate Governance Code, as amended 26 May 2010.



The role of the audit committee in remuneration oversight could become more formal over time

Views about the role of the audit committee in remuneration vary across markets. Research participants from the UK and the Netherlands typically saw a larger role for the audit committee in remuneration than those from other European countries. Perhaps not coincidentally, companies in the UK and the Netherlands have some of the more progressive remuneration practices and comprehensive disclosure requirements.

Still, audit committee involvement in remuneration is an emerging practice and typically not formalized. Involvement tends to be informal and, according to one participant, up to the board to create the right linkages between committees. Participants indicated that the most common approach to ensuring audit committee involvement in remuneration is via overlapping committee membership between the remuneration committee and audit committee. This allows the remuneration committee to enlist the expertise of the audit committee without burdening the full committee or diluting an already full audit committee agenda.

Links between the remuneration and audit committees may also be established through partnership and cooperation between committee chairs. One audit committee chair highlights how this can work. "If [the audit committee] is working through a change that might have an effect on the remuneration plan, I would make a point to talk to the remuneration committee chair after the meeting and say, 'Did you think of this?'"

While the role for audit committees in remuneration remains informal for now, there may be pressure to make it more formal. In 2009, a European working group of investors and audit professionals published guidelines that suggest a shift toward more structured interaction between the audit and remuneration committees. "The audit committee has an important role to assist these committees in ensuring that compensation policies and practices are consistent with an effective control environment," noted the report. "In particular, the board and/or audit committee should satisfy itself that key finance, control and risk management personnel do not have inappropriate performance incentives."²³ The guidelines indicate that the "audit committee should provide:

- ▶ A brief but informative description of its interaction with the compensation or remuneration committee in respect of executive compensation policies and practices; and
- ▶ Comfort that the compensation policies and practices for top executives, key business unit leaders and senior control and risk management personnel are, in its opinion, appropriate for maintaining a robust control environment, consistent with good stewardship, and the long-term objectives and risk appetite of the company."²⁴

The extent to which member states' regulators adopt these guidelines remains to be seen. One option is that they could be implemented on a "comply or explain" basis. Alternatively, they may be incorporated into the European Commission's legislative proposals that will emerge from its green paper consultations on audit policy and corporate governance, which are due later this year.

²³ Enhanced Disclosures Working Group, "Guidelines for Enhanced Disclosure to Assist Directors, Audit Committees, Shareholders, and Investors," 2009.

²⁴ Ibid.

Conclusion

For most audit committees, remuneration may not yet appear as an agenda item. But as scrutiny of pay and the potential for reputational risk grows, it is becoming increasingly important for audit committee members to provide input on key remuneration issues. Audit chairs are keenly aware that the financial expertise found in the audit committee can be instrumental in evaluating and improving remuneration plans. Trends to enhance the structure of pay (for example, the movement toward linking pay to sustainable performance metrics, such as total shareholder return) are also creating complexity in pay plans. This increases even further the need for audit committee involvement. And, as regulators continue in their push toward increased pay disclosures, companies and boards may be forced to enhance or clarify board-level oversight of this and other non-financial information, in order to avoid the risk of sending conflicting or confusing messages to the market. Leading audit chairs are already suggesting that they should have a wider review and greater controls over this information. For some, this is a role that they will have already assumed.

Appendix: Research participants

From March 2011 through April 2011, Tapestry Networks interviewed a broad range of board directors and subject matter professionals. All discussions were held under a modified version of the Chatham House Rule whereby views expressed during the discussions are not attributed to individuals or their organizations.

The following directors and subject matter professionals were interviewed:

- ▶ **John Anderson**, *Partner, Meridian Compensation Partners*
- ▶ **Nick Andrews**, *Senior Vice President and Partner, Fleishman-Hillard*
- ▶ **Auke du Bos**, *Assurance Services, Ernst & Young; Professor in Business Economics, Erasmus University*
- ▶ **Jean-Nicolas Caprasse**, *European Corporate Governance Head, Institutional Shareholder Services (ISS)*
- ▶ **William Claxton-Smith**, *Independent Director, Remuneration Consultants Group*
- ▶ **Claudia Kruse**, *Head of Corporate Governance, APG Investments*
- ▶ **David Dando**, *Director of Corporate Governance Programs, HQB Partners*
- ▶ **George Dallas**, *Director of Corporate Governance, Foreign & Colonial (F&C)*
- ▶ **Shade Duffy**, *Head of Corporate Governance, AXA Investment Managers*
- ▶ **Mark Edelsten**, *Director of Performance and Reward, Ernst & Young*
- ▶ **Marshall Franklin**, *Internal Audit Leader, Ernst & Young*
- ▶ **Mark Jobling**, *Assistant Director Investment Affairs, Association of British Insurers (ABI)*
- ▶ **DeAnne Julius**, *Remuneration Committee Chair, BP and Audit Committee Chair, Roche*
- ▶ **Joan Henkel**, *Director, Group Compensation & Benefits, Fiat Group*
- ▶ **Phil Hodgkinson**, *Audit Committee Chair, British Telecom*
- ▶ **Harry Hofman**, *Human Capital Services, Ernst & Young*
- ▶ **Vivian Joynes**, *Partner, HQB Partners*
- ▶ **Bob Leonards**, *Senior Manager Professional Practice Group, Ernst & Young*
- ▶ **John MacKay**, *Financial Services, Ernst & Young*
- ▶ **Christian Mouillon**, *Global Vice Chair, Assurance, Ernst & Young*
- ▶ **Felice Persico**, *EMEIA Assurance Leader, Ernst & Young*
- ▶ **Giovanni Quaglia**, *Head of Human Resources, Fiat Group*
- ▶ **Pierre Rodocanachi**, *Human Resources Committee Chair and Audit Committee Member, Vivendi*
- ▶ **Guyllaine Saucier**, *Audit Committee Chair, Areva and Danone*
- ▶ **Ulrich Skirk**, *Professional Practice Director, Ernst & Young*
- ▶ **Bryan Smith**, *Partner, Meridian Compensation Partners*
- ▶ **Kees Storm**, *Audit Committee Chair, Anheuser-Busch InBev and Unilever*
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EYG no. AU0891

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EMEIA MAS 137.0511