AMERICAN UNIVERSITY
WASHINGTON, DC

BENJAMIN LADNER
PRESIDENT

MEMORANDUM

November 22, 2004

TO: Compensation Committee

FROM: Ben Ladner and Don Myers

SUBJECT: Summary of Ernst and Young Consultation

An Ernst and Young financial advisor identified by former AU Board and Compensation Committee member Pete Smith recently recommended Mr. William Leisy, a specialist in the area of IRS regulations and executive compensation, as an expert who could provide helpful information about executive compensation issues.

Mr. Leisy, who is in the Atlanta office of Ernst and Young, has been a specialist in the field of compliance issues for executives for more than 20 years. He has worked directly with the IRS in representing client universities who have been selected for further examination with respect to executive compensation.

He agreed to a conference call with Don Myers and me recently. This memo is a summary of Mr. Leisy's professional observations.

SUMMARY

Mr. Leisy reported that there are three key requirements of intermediate sanctions, listed below.

1) <u>There must be an independent committee or board</u> making the decision about executive compensation— meaning that there can be no monetary connection or conflict of interest by the committee or board to the university. If the board establishes a committee to exercise this function, it must be clear that there are no monetary interests or connections that would compromise the independent judgment of the committee.

2) <u>An outside advisor should be used</u> to gather and report comparative data outside the university. There is no requirement or expectation that this advisor should provide a letter to the board. The point is that the university itself should not be the sole source of generating comparative data. It is also common and acceptable for the committee/board to search for and rely upon data sources beyond those provided by the outside advisor. The advisor's contribution comprises only one component of the overall judgment that must be exercised by the committee or board with respect to any individual's performance, situation, and compensation.

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3) There should be clear and consistent documentation of decisions by the committee. This, in fact, is the most important requirement, and it can be met by decisions and justifications being recorded in the minutes of meetings. The minutes then serve the same purpose and have the same standing as a consultant's letter.

It is important to underscore that compensation decisions rest with the committee/board and that it is the responsibility of the committee/board to take account not only of the consultant's data but also of individual performances, unique circumstances, university complexity, executive portfolios, length of service, cost of living, and the financial performance of the institution.

The market numbers reported by outside sources (both the consultant's and other data sources) are, of course, what the market numbers are; but they can be delivered differently with respect to particular executives in actual circumstances. The IRS does not look at simple comparability but at what is unique about an individual's compensation relative to his/her actual situation.

The market has made clear that providing annual incentives for executives is legitimate. Actually, AU is probably in a stronger position than most universities to justify its use of annual incentives because unlike many universities that provide incentives only for the president, AU distributes incentives to all its executives, which is a more equitable approach. The questions IRS will ask are what was paid, to whom, and why.

AU is in a strong position to justify its executive compensation decisions by virtue of the fact that the university established and implemented pay-for-performance standards for the entire university some years ago, with outside assistance from Mercer. These standards have been successfully integrated into all faculty and staff compensation decisions that are made each year in light of clearly identified performance goals.

It is helpful to remember that comparative "raw data" numbers are, after all just that: raw data. If this were the only rationale required for making decisions about compensation, there would be no need for intermediate sanctions; a university could simply fit compensation numbers into objective data-boxes.

In fact, there is a significant difference, recognized by IRS, between raw numbers and appropriate numbers, which take account of all factors relevant to the unique circumstances of a university and individual executives. For this reason, it is permissible for the committee/board to decide to exceed reported market numbers and levels for any individual executive. The point is that executive compensation decisions should not be made randomly and without discretion, but should be linked to clear justifications.

The key for the IRS will always be documenting the justifications for decisions and for how the compensation package is delivered. Therefore, the committee/board should

know and report the total cost of executive payments each year, and show how this total breaks out for individual executives.

It is also worth noting that 18 months ago AU was randomly selected for a detailed audit by the IRS, with special attention to 457(f) and 403 (b) plans. For nearly two years, IRS staff has been on site at AU reviewing the university's compliance with these plans, which, by necessity, has involved a broad review of AU executive compensation policies.

Mr. Leisy reported that so far the IRS has conducted 40 such reviews of universities nationally and found all 40 to be out of compliance. By contrast, just last week we received verbal confirmation that a letter would be forthcoming confirming that AU is in substantial compliance with IRS regulations (with only a few minor items noted, which the university had already self-reported). According to Mr. Leisy, AU would be the first university to have been reviewed positively with a clean bill of health with respect to such compliance.

To be sure, the IRS focused only on two specific compensation plans. However, in the process of it comprehensive review it also reviewed AU's executive compensation policies and found no difficulties. Mr. Leisy concurred that there is at least some basis to presume that it is unlikely that AU would be a target for an executive compensation review on the heels of this audit, especially since the university has been operating within a reasonable and explicit framework for making compensation decisions.

According to Mr. Leisy, it appears that the AU committee/board is well within its rights— indeed, it is precisely the special responsibility of the committee/board— to make compensation decisions against the background of available data. These decisions usually are not restricted to a single source but, instead, reflect a business judgment made by the committee/board about the value of the performance of a particular individual in a specific institution. Again, the committee must document the reasons for its decisions.