

**IPPF – Practice Guide**

**AUDITING EXECUTIVE  
COMPENSATION  
AND BENEFITS**

**APRIL 2010**

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## Introduction

Executive compensation and benefits (ECB) programs have risks that require effective board governance (direction and oversight) and management (development, monitoring, and administration) processes. Internal auditors have an important role in providing assurance that appropriate and effective controls are in place around ECB programs.

Auditing the structure and operation of ECB programs is a legitimate and appropriate role for internal auditing. If a risk assessment indicates a review is warranted, the chief audit executive (CAE) should add ECB to the audit plan, which the board will review and approve. Internal auditing will choose the audit approach and design risk-based audit procedures.

This practice guide is not intended to address all the considerations necessary for performing an audit of ECB. It provides discussions relating to such an audit and includes several considerations that may be relevant to an organization's business activities or risk profile.

The International Professional Practices Framework's (IPPF's) *International Standards for the Professional Practice of Internal Auditing (Standards)* include attribute and performance standards pertaining to activities of internal audit, including audits of ECB programs. This practice guide assumes conformance with the standards for all audit work and discusses how the execution of such audit work could be performed.

## Executive Summary

Strong governance systems are needed for ECB programs, as management often is in the position of both designing and recommending its own compensation. There

are several specific risks internal auditors should consider, including employment market, compliance, financial reporting, reputation, operating, and external business relationship risks. ECB programs also are subject to fraud risk.

Due to the sensitive nature of this area, internal auditing must have an appropriate audit approach and access to the necessary information. While there can be obstacles to obtaining this information, internal audit needs to proceed in accordance with its charter.

The audit scope could include a focus on the board, management, and extended business relationships.<sup>1</sup> There are a number of unique aspects in audits of each of these areas of focus which should be considered before performing audit work.

## Definition and Structure

Compensation and benefits are the aggregate of various payments, reimbursements, and personal use of assets that are a benefit to the employee and a cost to the organization. The cost can be direct costs for the benefits, or incremental costs, such as administration. The components of ECB vary among organizations; significant differences may exist among organization types (publicly or privately held, government, not-for profit, etc.) sizes, and locations. Components of ECB include salary, bonuses, perquisites (fringe benefits), equities, and some reimbursable business expenses. For additional discussion and examples, refer to Appendix A.

Boards<sup>2</sup> review and approve compensation strategies to attract and retain appropriate leadership for the organization, while managing stakeholder expectations for cost management and alignment of compensation with the organization's performance.

<sup>1</sup> External business relationships include suppliers, customers, and partners. For more guidance, refer to the IIA Practice Guide "Auditing External Business Relationships."

<sup>2</sup> A board is a governing body, such as a board of directors, supervisory board, head of an agency or legislative body, board of governors or trustees or a non-profit organization, or any other designated body of the organization. For this guide, board may also refer to committees of the board.

Management is often in the position of designing and recommending its own compensation programs, as well as board compensation programs. Strong board governance systems are needed to manage the inherent conflict of interest and potential for collusion.

Many organizations outsource compensation and benefit services, such as pensions, medical and insurance benefits, financial and tax planning services, recruitment, and outplacement. Some may outsource processing functions, such as payroll and accounting. Outsourcing adds additional complexity and risk over monitoring of controls and creates a challenge when trying to understand the full spectrum of controls in place.

## Risks

ECB exposes organizations to several risks. The board and management have ultimate responsibility for assessing and managing these risks.

The CAE should understand and assess these risks to determine the need for an audit and for planning, scoping, and resourcing. Some of the risks identified herein may cover more than one risk category, and many are also ethics/fraud risks.<sup>3</sup>

### Employment Market Risk

If the ECB is not competitive in the employment market, the organization may fail to attract or retain individuals with the necessary and desired qualifications to fill key roles. The organization could fail to achieve its goals and objectives due to weak leadership.

### Compliance Risk

The organization may fail to comply with laws and regulations if:

- It does not know or understand the applicable laws and regulations.

- It fails to design controls.
- The processes for gathering and reporting regulatory required ECB data is not reliable (accurate, complete, timely, etc.).
- Management intentionally or unwittingly designs processes that fail to apply regulations appropriately, such as employment benefits, income tax regulations, or accounting standards.

The organization may fail to comply with its policies and procedures if:

- Executives make illegal or unethical decisions to generate more personal benefits than those approved.
- The board fails to act responsibly in meeting its governance role.
- The organization may fail to comply with contractual or other legal obligations if:
  - It does not generate sufficient resources to pay for agreed-upon severance and post-retirement benefits, or if such resources are not appropriately safeguarded.
  - Processes are not designed to manage customer or joint venture billing requirements. For example, some contracts may stipulate what types or percentages of compensation and benefits are chargeable, and such terms and conditions may differ among customers and partners.

### Financial Reporting Risk

The organization may:

- Misclassify or hide over-generous, illegal, or unethical ECB, which could also lead to failure to disclose (compliance risk).
- Misclassify or misreport financial or operating data to create the illusion that goals were reached (to qualify for bonus payments or to improve/retain the market value of equities, for example).
- Report incorrect valuations or inappropriate es-

<sup>3</sup> For more information, refer to the IIA publication "Managing the Business Risk of Fraud, a Practical Guide." The document also discusses governance and audit procedures relevant to this topic.

timates and accruals due to poor accounting and disclosure controls.

## Reputation Risk

The organization may:

- Create internal morale issues if executives are eligible for inequitable or unreasonable ECB.
- Fail to effectively develop, communicate, and defend the ECB strategies, exposing the organization to challenges by shareholders, employees, media, government, and other stakeholders. Stakeholders value transparency and organizations that accept accountability for their decisions. An organization's reputation can be negatively impacted if stakeholders perceive the ECB programs are rewarding failure or socially unacceptable behavior, especially when the organization is government funded or not-for-profit. The organization should screen its strategies and communications periodically to consider social and economic factors.

## Operating Risk

The organization may:

- Introduce a high opportunity for error or fraud through the design of complex ECB programs. ECB programs may have high inherent risk where they involve many systems and departments, in-house and third party administrators, and/or are highly regulated. A complex legal structure in the organization is often associated with a more complex EC structure which increases inherent risk of error.
- Fail to design appropriate governance processes and internal controls, resulting in inadequate feedback and oversight to improve processes, inadequate controls over inherent conflicts of interest in board compensation and executive compensation, or pressures leading to management override of controls.
- Fail to achieve its goals and objectives if the ECB is

poorly designed and fails to motivate executives.

- Fail to optimize costs (and meet shareholder expectations) if the ECB is not linked to organizational performance, both short and long term. However, linking excessive portions of compensation to performance may encourage fraud or other illegal or unethical behavior. An excessive portion of compensation linked to short-term performance targets increases this risk.
- Fail to optimize costs if the full financial impact is not considered when developing ECB strategies. For example, some benefits may be attractive to executives but may not be deductible expenses when calculating the organization's income taxes, or may not be recoverable as part of 'overhead rates' from customers. Increases to ECB in response to tight employment markets may also not be removable once market conditions improve.
- Encourage behavior that is inconsistent with the interests of relevant stakeholders (e.g., bonus practices may reward excessive risk taking or, alternatively, create a culture that does not innovate).

## External Business Relationships

The organization may fail to:

- Adequately provide for control requirements in contracts with outsourced service providers, such as those that process payroll, pensions, etc.
- Monitor controls over information administered by outsourced service providers.

## Audit Approach

The CAE's decision to perform an audit, the approach, scope, and sample size, should be based on a risk assessment of the subject, including the inherent risk of the processes and potential consequences.

Internal auditing should determine whether ECB will be scoped as one audit or a series of audits. The audit(s) could be further refined into reviews at subsidiary or division levels; reviews of board compensation and benefits and executive compensation and benefits; and reviews of processes administered by the organization and those administered by outsourced service providers.

If internal auditing typically conducts audits of departments rather than processes or subjects, proposing an ECB audit would be different from the usual approach because it crosses departments and requires the cooperation of many department heads. The CAE could choose to break down the subject into departments, such as human resources (HR), payroll, legal, accounts payable, etc., so that each audit would cover the issues required to ultimately form an opinion at the macro level.<sup>4</sup> Audit recommendations may also require the involvement of many departments and, if significant, may require CEO acceptance. The CAE should anticipate challenges and consider this deviation from the norm in the audit plan.

There might be some concern from members of management or the board if internal auditing will be evaluating board governance of ECB and it has never audited board processes before. However, board governance is a significant control factor in ECB and usually is included in the audit scope. The CAE may choose to conduct two audits, one of the board processes and one of management processes, before forming an opinion. Another approach is to review the board processes as a consulting engagement rather than as an audit.

Generally, an audit of ECB is a subset of the employee compensation and benefit programs audit and is not a comprehensive audit of all the systems used to administer and account for ECB. This guide assumes that the payroll, accounts payable, banking, etc. functions are risk

assessed and subject to separate audits.<sup>5</sup> Internal auditing should consider the results of these audits when planning the ECB audit program. If these functions are not audited independently, additional testing may need to be done, including testing of relevant general information technology (IT) and application controls.

In some organizations, the board or management requests that internal auditing conduct specific tests on ECB related issues, such as an annual audit of executive expense accounts. With the knowledge gained from a risk assessment or ECB audit, the CAE could consider approaching the board with a plan that would replace the annual audit with a higher risk process, expand on the audit, or rotate two or three key processes, to optimize risk assurance and audit resources

The CAE also could approach an evaluation of ECB as a consulting engagement, e.g., as a proactive review of ECB to identify whether there are any issues that may be control weaknesses, embarrassing, or controversial. Because ECB issues are often sensitive and developed at a senior level, facilitating a control self-assessment by management is not an optimum approach.

### **Auditing Board Compensation and Benefits**

Management may develop recommendations for board compensation and benefit programs, creating an opportunity for collusion or conflict of interest in board compensation. The CAE determines whether to include board compensation and benefits in the audit scope, and whether to test for board member use of assets and receipt of payments. This determination should be consistent with the charter of the internal audit activity. If the audit scope includes the board, audit tests could include board member names wherever the considerations included in the Audit Program Development section of this guide mention “executives and their families.”

<sup>4</sup> For more information on forming opinions, refer to the IIA Practice Guide “Formulating and Expressing Internal Audit Opinions.”

<sup>5</sup> The results of those audits may impact the reliability of the data used in an audit of ECB.

If management applies pressure to internal auditing regarding the audit work program and results, the CAE can seek support from the board.

### Auditing External Business Relationships

If internal auditing has never audited external business relationships, and the risk assessment indicates that an audit is warranted, the CAE needs to determine whether the organization has the right to audit under the contract and ensure that an appropriate audit reporting process is developed.<sup>6</sup>

## Audit Considerations

Executive and board compensation is often subject to public disclosure requirements, accounting standards, and external auditing. This should be factored into the nature of work performed. For example, the external auditors may have reviewed the completeness and accuracy of reported benefits but not reviewed the controls for ensuring appropriateness of those benefits.

If the board has not approved an audit of ECB as part of the annual audit plan, the CAE should obtain such approvals and buy-in to the scope before beginning. This action provides the CAE with the support necessary for such a sensitive topic and reduces impediments to the audit process.

### Access to Information

If there is no internal audit charter, or if the charter is not clear about access to records, facilities, and personnel, the CAE could use some of the risk, control, and governance factors identified in this guidance to convince the board and management of the value of such an audit and to gain cooperation regarding full access.<sup>7</sup> The CAE may request that the chairman of the board and the CEO issue a memorandum to the relevant board members and department heads stating their support for the audit and encouraging cooperation from all parties.

Regardless of executive and board support, auditors may encounter some resistance from personnel in the HR or payroll functions. Part of their responsibility is to ensure confidentiality and they may try to restrict the auditors. Their level of concern is usually greater when dealing with information about executives or pending program changes that have not yet been approved or announced. Auditors need not be intimidated or frustrated by this issue, rather they should be aware of, and respect, these concerns, while still getting the job done. Auditors can help these personnel understand the internal audit activity, the scope of access, the auditor's professionalism, and how the information will be used and protected. Being responsive to concerns may help reduce conflict and may require being innovative in the audit approach or practices. For example, the audit team might use senior level staff, such as audit managers, to perform some of the more sensitive tests, such as review of board materials.

### Privilege

In some countries, certain organizations have the right to invoke privileged communication between the organization and its legal counsel. Management or the board might invoke this right, and the CAE may be directed to conduct the audit and communicate results in conformance with legal requirements. To comply, the CAE must understand how legal privilege applies to the organization and to internal audit work.

The CAE should consider the liability risk associated with the audit, such as when an audit is initiated in conjunction with a fraud investigation. The CAE should consult with legal counsel before beginning such an audit, as this situation may be cause for invoking privilege.

### Skills and Knowledge

Due to the sensitive nature of ECB, and the senior level personnel involved, auditors should be discreet, tactful, and confident. Generally a more experienced, senior-level auditor is part of the team.

<sup>6</sup> For more information, refer to IIA guidance "Auditing External Business Relationships."

<sup>7</sup> Refer to the International Professional Practices Framework Standards and Practice Advisories relating to key elements of an internal audit charter to effectively establish or modify a charter for your organization.

ECB transactions in most organizations are recorded in electronic systems applications. Extracting and analyzing data and crosschecking between databases usually require the audit team to have IT skills and to use computer-assisted audit techniques.

## Audit Program Development

This section includes various concepts, potential tests, and questions to help auditors create an audit program. It is not a comprehensive list, nor should all of these considerations be tested. As always, the risk assessment should lead to development of an appropriate program.

### Board of Directors and Committees

A critical board role related to ECB is to balance the interests of shareholders (risk management and fiduciary responsibility) with those of management (who desire to be paid well commensurate with work performed). The board needs to approve a strategy that balances short- and long-term goals and attracts, retains, and motivates people to achieve those goals in an ethical culture. The board is also responsible for managing the other ECB risks relevant to the organization and managing the expectations of other stakeholders.

The conflict of interest risk in ECB warrants board responsibility for risk assessment, approval, and monitoring. Most organizations use a board committee — the compensation or HR committee — to perform this role. Many organizations structure such a committee to be independent from management, with the right to retain outside advisers (legal or subject matter experts) to assist in evaluating strategies and programs.

When designing audit procedures appropriate for the organization and scope, there are several considerations.

1. Board and committee terms of reference, minutes, agendas and information packages relevant to ECB.

- Is there enough information provided, with enough time to deliberate and ask questions before making decisions? Is the information complete and accurate?
- Are the board members qualified, and do they have independent,<sup>8</sup> qualified advisers to help them make appropriate ECB decisions?
- Is the board seeing the full scope of ECB, or just a few elements (such as base salary and annual cash incentive awards, without considering long-term equity awards)?
- Is the information system used for gathering and summarizing information reliable?
- Are the organization's programs benchmarked? Are the appropriate industries/competitors selected for benchmarking? Is benchmarking causing unintended consequences such as a bidding war or "competition of egos"?
- Does the board understand the organization's required disclosures and disclosure controls, and does it approve disclosure of ECB?
- Does the board review and approve all relevant aspects of the pension, profit sharing, and similar funds (e.g., fund managers, fund investment strategies, audits, disclosures, and valuations)?
- Does the board receive and discuss results of ECB audits by regulators or customers? Is the board reacting appropriately to such information?
- Is there evidence of approvals for new ECB programs and for material changes? Are board approvals made in compliance with bylaws and granted authorities?
- How are board compensation and benefits determined? Are independent and qualified advisers used? Are board compensation and benefits programs benchmarked? Are they aligned with performance results?

<sup>8</sup> Consider the volume, value, and types of other consulting work done for the organization by the advisory firm when evaluating the adviser's independence.



2. Board self-assessment surveys and results (considering the impact of the responses in relation to ECB governance).
  - Is the board satisfied with its processes? With management information? With its independence? With its use of external advisers?
3. Board performance evaluations of the CEO and other executives.
  - Is it a reasonable process, and is it done frequently enough? Is there a balance of short- and long-term objectives? Are the compensation and benefit awards aligned with organizational and individual performance? Are all appropriate performance criteria included?
  - Is the board reviewing the performance evaluations and subsequent compensation and benefits that the CEO awards to his or her subordinates?
4. Key employee retention plans.
  - Is the board considering the impact of ECB on key employees identified in the retention and succession plans?
5. Employment contracts and termination agreements.
  - Has the board signed any employment contracts with the CEO or other executives? Did the board obtain independent legal counsel?
  - Have the terms and conditions been integrated into the board's risk discussions? Have they been disclosed appropriately? Have they been accounted for appropriately?
  - Does the board review employment contracts signed by the CEO for other executive positions?
  - Do termination agreements appear to reward failure (e.g., severance paid to "keep quiet" or bonuses paid when results are poor)?
6. ECB strategies and objectives.
  - Has the board articulated its ECB strategies and objectives? Are the strategies designed to motivate appropriate behaviors? Is the board monitoring results? Would the strategies be deemed appropriate by media, the public, or other stakeholders?
  - How does the board deal with special circumstances? For example, if share market price is an element of the bonus program, it is generally assumed that management can impact the value of the organization, and therefore the share price. But is the bonus program re-evaluated when significant market swings occur (either up or down) that management cannot influence? Does the ECB consider change of control (mergers and acquisitions, majority ownership, or significant change in board membership)?
  - What is the strategy related to post-employment benefits and severance (e.g., golden handshakes or golden parachutes)?
  - Does the ECB strategy balance the tangible (money, assets) with the intangible (culture, opportunities, monitoring, status, mission) to attract and retain appropriate personnel?
  - Is the board aware of, and satisfied with, how much HR and payroll costs (direct and administrative) are expended on behalf of executives and how much for other employees?
  - What is the strategy for offering allowances, rather than reimbursement of expenses? Is it reasonable and cost-effective?
  - How does ECB fit into the organization's risk assessment, and what controls have been adopted to ensure success?

Along with reviewing documents, the internal auditors can gather information by surveying the board and committee members and/or interviewing them.

## Management

There are a significant number of management responsibilities involved in developing, administering, and monitoring executive compensation, so reasonable attention is required when planning and scoping the audit. For example, a simple objective, such as “Is the organization in compliance with disclosure regulations?” requires review of many systems, such as payroll, accounts payable, cost center accounts, board processes, contracts, and regulatory filings and may extend beyond the organization into external business relationships.

Internal auditors need to evaluate their organization, regulated compensation and benefits for their operating locations, and employment contracts for examples of potential ECB to be scoped into their audit programs. Any departments that could pay, reimburse, or pay suppliers on behalf of executives and their families, as well as those departments that manage company assets, might be included in the scope.

There are several considerations when designing audit procedures appropriate for the organization.

1. Compensation policies and procedures.
  - Have they been approved by the board? Have they changed, and are the changes significant? Are they aligned with other board and management strategies? Are all compensation programs aligned within the organization, consistently rewarding or penalizing similar behavior or actions?
  - Are they administered effectively and applied consistently and fairly by managers?
  - Are proportions of short- and long-term, fixed and variable (at risk), legally required benefits versus optional, cash/non-cash reasonable? Are they competitive in the market? Are they consistent with industry standards?
2. Payroll.
  - Do they cover post-retirement ECB (e.g., medical and pensions)?
  - Are the salary and benefits complete and accurate (e.g., approved programs and increases/awards)?
  - Are classifications, computations, withholding, remittances, and filings compliant with regulatory and contractual requirements?
  - Do IT controls prevent unauthorized changes?
3. Accounts Payable.
  - Are expense accounts in compliance with company policies, regulatory requirement, and contractual obligations?
  - Can the vendor master be compared with the check register for payments made to executives or their family members (e.g., address matching)?
  - Do IT controls prevent unauthorized changes?
  - Are expense accounts of executive assistants unreasonable, or are the executive’s expenses claimed by the assistant and approved by the executive?
  - Can accounts payable and treasury records be crosschecked with addresses from HR for payments sent to executives or their family (for active, retired, and terminated employees)?
  - Can the “ship to” addresses from purchase orders be crosschecked with employee addresses?
4. Corporate treasurer or finance function.
  - Are cash advances or petty cash reimbursements to executives or family members used appropriately? Are advances cleared appropriately, in compliance with policies and procedures?
  - Have wire transfers to executives, their families, and organizations commonly known to supply

perquisites (e.g., for vehicle repairs, golf or entertainment facilities, clubs, transportation, and gift shops) been accounted for appropriately?

- Have share transfers to executives and family members been controlled appropriately? Are regulations affecting securities trading complied with (e.g., trading bans and blackout periods)? Do compensation or benefits that are paid as shares, rights, warrants, or options (related to company stock) require strong controls to ensure valuation, accounting, disclosure, and taxation are handled appropriately?
- Do payments made to the organization by executives indicate undocumented loans or reimbursement for personal use of the organization's credit card?

5. Audit results and action plans.

- By regulators, such as government tax authorities or securities exchanges.
- By customers, who may have the contractual right to audit direct costs or rates charged.
- By external auditors for compliance with accounting standards, disclosure requirements, and ethics or risk management issues.
- Does management's strategy appear to be "We'll do it this way until we get caught"? Are internal control weaknesses addressed timely and appropriately?

6. Market surveys, employee satisfaction surveys, and benchmarks.

- Do results indicate ongoing or pending issues? Have they been reviewed with the board and executive management?

7. Public perception.

- Does the company receive recognition, such as "Top 10 Companies to Work For," "CEO of the

Year," news clippings regarding ECB, etc.?

- Do payments from executive programs appear to reward failure—for example, a bonus paid to an executive for achieving targets through significant lay-offs or facility shutdowns? This action could lead to public outrage if the perception is that the executive's income is more important than the employees' incomes. Other examples include significant payments to executives who are terminated for failure to perform (golden parachutes) or to encourage an executive to "go quietly."

8. Employment contracts, including termination and loan agreements.

- Are employee loans legal? If so, are there any regulatory restrictions that apply to loans?
- Are the loans given at market interest rates, or below? Are repayment terms reasonable, and are they being met? Is there collateral/security for the loan? Check for loan write-offs or loan forgiveness.
- Are key executives entitled to any of their employer's products or services free of charge or at a discounted rate? If so, is this appropriately recorded and approved?

9. Turnover statistics, exit interviews.

- Do results indicate ongoing or pending issues? The auditor may expand the audit program based on these results.
- Have these results been reviewed with the board and executive management?

10. The administrative cost center charges for executives/administrative assistants.

- Are there charges paid directly to vendors where the executive benefits? These could include charges for clubs, travel, gifts, and entertainment. If so, have the charges been approved and reported/classified appropriately?

11. Facilities and equipment.

- Can use of the organization's assets by the executive and his or her family provide useful information to evaluate potential ECB (e.g., by checking logs and manifests)? Assets to consider include company vehicles (e.g., planes, trains, automobiles, trucks, boats, snowmobiles, and jet skis), housing (e.g., homes, apartments, resorts, cabins, trailers, hotels, and camps), dining and entertainment facilities (e.g., cafeteria, catering contracts, restaurants, meeting rooms, theatres, and auditoriums), and computers and telecommunications (e.g., laptops, blackberry devices, phones, printers, photocopiers, cameras, and software).
- Are some of the assets located in personal residences?

12. Financial reporting.

- Are accounting and financial reporting correct? For example, are costs in the right accounts, cut-offs appropriate, accruals, estimates and valuations appropriately applied to transactions, commitments, and agreements? Are significant variances explained?

13. Public and Regulatory filings (ECB related, such as disclosures and taxes).

- Are they complete, accurate, and timely?
- Are descriptions of ECB elements clear and understandable, providing the right level of transparency?
- Are ECB amounts accurately presented, derived from processes with sufficient internal controls?

14. Double dipping.

- Is it possible for an executive to be reimbursed twice for some expense? The risk of double dipping is greater when a different system or

department than the general employee benefit payment system handles the executive payment/reimbursement process (e.g., one reimbursement processed through payroll and another through accounts payable). Take for example reimbursement of employees at a specific rate for each mile/kilometer driven (to cover operating and capital costs) when the executive is also provided with a vehicle or vehicle allowance.

15. Employment taxes.

- Are benefits handled via accounts payable or similar, non-payroll functions?
- Are specified benefits taxable in one jurisdiction (country, state, or province, etc.), but not taxable in another? If so, is the organization treating the benefits appropriately on tax returns and financial statements?

16. Metrics Used for Calculation of Compensation.

- Are compensation amounts based, at least in part, on specified metrics? If so, are metrics easily verifiable (e.g., based on public external data such as stock price or revenue growth) or dependent on internal data which is not as easily verified?

17. Override of ECB controls.

- Is it possible for management to override controls in ECB, including IT controls? For example, executives could apply pressure on clerical staff or their administrative assistants.

### External Business Relationships<sup>9</sup>

Many organizations outsource compensation and benefit services as well as payroll and accounting services. If vendor audits have been scoped into the audit plan, some of the previous review considerations may need to be performed.

<sup>9</sup> For more information, refer to the IIA Practice Guide "Auditing External Business Relationships."

Reputation risk is often based on association with, deemed influence over, or deemed agreement with ECB policies of business partners. For example, an executive may receive remuneration as an officer of a related organization. If joint venture or partnership arrangements are included in the scope, consider designing your audit program with the following considerations.

Within your organization:

- Do contracts include a “right to audit clause” and requirements for confidentiality? Have they been approved appropriately?
- What are the criteria for selecting vendors and were they followed? How is vendor performance measured and reported?
- What proportion of the vendor fees are related to serving executives versus other employees?
- How are vendor controls monitored by the contract or program manager?

Within the service provider’s organization:

- Are there adequate IT controls to protect the organization’s information? Attestation standards from public or regulatory audit standard setters are a source of information.
- Are distributions to executives accurate and complete? Are they compliant with policy? How are changes authorized?
- Is there evidence of the organization’s entertainment of executives (vendor expense accounts and promotional activities such as golf tournaments, fishing or resort trips, and gifts)? Is it consistent with both organizations’ policies?
- Is there evidence of possible conflict of interest with the vendor’s customer list? For example, a board member works for an organization that is also the

vendor’s customer.

External organizations may restrict access to certain processes or information. Internal auditing may need to use an independent third party to perform all or part of the audit and provide assurance.

## Appendix A – Types of Executive Compensation and Benefits

There are many compensation and benefit types, but those discussed herein are generally unique to executives, or where executives receive enhanced programs and payouts compared with other employees.

To determine which ECB programs to include in the scope of an audit, auditors should consider the unique aspects of the ECBs of the organization, employment contracts, regulated compensation, and complexity of the organization.

Family members also may obtain benefits that are attributable to the executive. Some benefits are considered taxable income for the recipient and some are not deductible by the organization for tax purposes (varies based on legal jurisdiction). Some compensation and benefits are legally mandated, while others are discretionary (varies based on legal jurisdiction), and some forms of benefits may be considered illegal in some jurisdictions.

If the organization offers any ECB programs to contractors, the internal auditor should consider the potential legal and ethical impacts.

### Compensation

**Allowance:** Fixed payments paid periodically to reasonably approximate the employee's costs for a particular type of expense (e.g., car, housing, and clothing allowances). Once received, employees may use the money as they choose.

**Awards:**<sup>10</sup> Similar to a bonus, but most often used to reward individual goal achievement (e.g., safety milestones or years of service) or for unexpected or extraordinary

performance. Awards may be paid as a fixed amount or a percentage of salary, and may be paid in currency, shares, gift cards, property, or services (e.g., vacations, cars, jewelry, and spa treatments).

**Bonus:** Remuneration paid for achieving a specific goal. Bonuses may be structured for short- or long-term performance of the organization, department, or individual. Bonuses are generally paid once, then must be earned again. Bonuses may be paid as a fixed amount or a percentage of salary, and may be paid in currency, shares, stock options, property, or services (e.g., vacations, cars, jewelry, and spa treatments). Bonuses based on organization goals may be referred to as profit sharing, gain-sharing, “tantieme”, or incentive plans. Gain sharing is a program that returns cost savings to the employees, usually as a lump-sum bonus. It is a productivity measure, as opposed to profit sharing, which is a profitability measure.

**Commission:** Pre-established remuneration paid for achieving specific sales (per piece, volume, or value based) or a marketing service goal (e.g., referrals to new customers or entry into new markets).

**Pension:** A fixed or variable rate of remuneration paid periodically to a former, qualified employee (or his or her beneficiary) who has reached a specific retirement age or is deceased. Pension plans are often defined benefit plans or defined contribution plans and are highly regulated in many countries. Employees may receive pension payments from both their employers and from governments. Pension plans may be combined with insurance schemes in superannuation plans or provident funds for the welfare of the employee. Executives generally have enhanced pension plans that exceed the standard for other employees. A company may offer various types of retirement plans (e.g., qualified for preferential tax treatment or non deferred benefit plans) and all should be reviewed for benefits due an executive.

<sup>10</sup> In Australia, an award is a pay scale related to an industrial agreement (union led); however, in many international organizations, an award is as described in this appendix.

**Perquisites:** Benefits (often called fringe benefits) offered at the employer’s discretion, rather than benefits required by law. Examples of perquisites include company cars or car allowances, parking, airline lounge memberships, and use of corporate jets. Perqs (colloquial term) are often seniority based and may also include the “right of first refusal” for event tickets, job openings, conference attendance, etc.

**Severance:** Remuneration made to an employee upon termination from the organization. Severance can take the form of a lump sum payment or may be paid out over a specified period. Severance may be paid as a fixed value or a percentage of salary, and may be paid in currency, shares, property, or services (e.g., health-care benefits, outplacement services, cars, jewelry, club memberships, and access to employee discounts). Severance is generally determined by laws and company policy, which is influenced by case law (from court rulings on cases of challenges to severance pay). Executive severance that has been pre-agreed in an employment contract is often referred to as a golden handshake or a golden parachute. Severance may also be referred to as a gratuity payment. Executives generally receive enhanced severance programs compared with other employees.

## Benefits

**Athletic or Cultural Facility Seats:** The purchase of seats or facilities (boxes) in sports arenas or performing arts centers with the intent to use the tickets for entertaining customers and as employee rewards. Personal use of the tickets by executives, directors, and employees is considered a benefit.

**Athletic, Cultural, Dining, and Travel Club Memberships:** Reimbursing or paying directly for employee (and/or family) memberships in health clubs (e.g., gyms, spas, pools), sports clubs (e.g., golf or tennis), entertainment clubs (e.g., gambling, dining and dancing), and airline lounges as benefits.

**Financial and Retirement Planning:** An allowance or service that assists the employee in creating and managing a personal financial plan and budget. Accounting and tax preparation services, as well as advising on investment and tax strategies, also may be included.

**Gifts:** Gifts can include currency (e.g., cash or gift cards for retail outlets), shares, property, or services (e.g., vacations, cars, jewelry, and spa treatments) given to employees. When business property that is regularly used by the employee is given to the employee upon termination, this is considered a gift (e.g. office furniture, phone, computer, and tools).

**Health Examination Allowance:** An allowance typically up to a certain value for a periodic health examination.

**Insurance:** Payment for all, or a portion of, premiums for life and disability insurance, medical and dental care, unemployment insurance, home and car insurance, etc. The organization may also choose to self-insure and pay directly for any of these types of losses, or they may reimburse employees for all or a portion of insurance coverage or deductibles.

**Loans:** No- or low-interest loans to employees for relocation, purchase of company shares, purchase of home computers, etc.

**Outplacement:** Services provided to assist terminated employees in preparing for and finding employment elsewhere.

**Personal Use:** Free, personal use of company facilities or equipment, such as housing, dining rooms, hotels, resorts, computer and communication technology, recreational vehicles (e.g., snowmobiles, jet skis, yachts), theaters, and cameras. Free personal use of the organization’s services is also a benefit, including beauty treatments, professional services, facility and equipment maintenance, decorating, delivery, and use of staff to help with a personal activity.

**Relocation:** Covers the costs associated with transferring an employee to a new location. Benefits are often derived from the types of costs covered by the relocation program. For example, allowances may be paid for miscellaneous costs, loans to purchase houses, signing bonuses, remote location allowances, storage of personal effects that remain behind, tax and financial planning services, passports, language training, guarantees of spousal income or spousal placement services, guaranteed paid trips to alternate locations (e.g., family visits), tuition fees and school searches for children, maintenance of recreation property, and paid leave for moving.

**Savings and Investment:** Programs that facilitate and administer employee savings. Many organizations choose to contribute to such investments.

**Security Services:** Usually provided as a result of threat assessments and risk management programs, but they also may have a personal benefit associated with them. Examples of security services include personal bodyguards, alarm systems or patrols in the homes of executives, home safes or panic rooms, and self-defense training. Security Services may also be known as Executive Protection Programs.

**Transportation:** Transportation available to employees, and/or their families, for personal use (i.e., no business purpose can be rationalized, or the transportation is deemed as personal by regulations). Benefits take many forms, including:

- Allowances.
- A vehicle — where the organization purchases or leases a car, truck, etc. A process for reimbursement of operating expenses often accompanies this benefit.
- A vehicle and chauffeur.
- Parking.
- Airline lounge memberships.

- Public transit passes or tickets.
- Transportation from home to work (e.g., by bus).
- Use of the company airplane, train, or boat.
- Purchase of airline tickets or vacation packages.
- Frequent flyer points from trips taken for business purposes, if the employee is able to use the points for personal travel.

**Taxes:** When the organization pays the employment/income taxes on behalf of the employee, by paying the government directly, by reimbursing the employee, or by increasing bonus payments to cover the estimated cost of taxes.



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## About the Institute

Established in 1941, The Institute of Internal Auditors (IIA) is an international professional association with global headquarters in Altamonte Springs, Fla., USA. The IIA is the internal audit profession's global voice, recognized authority, acknowledged leader, chief advocate, and principal educator.

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