

EXECUTIVE COMPENSATION: IT PAYS TO REVIEW

Executive compensation is a perennially hot topic. The U.S. Securities and Exchange Commission (SEC) requires “clear, concise and understandable disclosure about compensation paid to CEOs, CFOs and certain other high-ranking executive officers of public companies.” While such disclosure provides transparency into this thorny topic, it also reveals new causes for shareholder and employee concern: Why is the CEO getting a huge bonus though company performance is down? Why is the gap between executive pay and employee wages so wide?

Such concerns create risks to the enterprise and, as a result, call for attention from internal audit. Yet, executive compensation is not high on the to-do list of many internal auditors. In The IIA’s 2015 Common Body of Knowledge (CBOK) study, nearly 70 percent of respondents said they devote minimal to no effort in looking at executive compensation. One reason: the extreme sensitivity surrounding the topic and the potential career risk involved in examining — and possibly questioning — their bosses’ compensation.

Excessive executive compensation can indicate a weak board and inadequate decision making, according to Moody’s Investor Services. So, while assessing executive compensation packages may not be the most comfortable exercise for internal auditors, it is a necessary one.



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The Institute of Internal Auditors Inc. (IIA) is a global professional association with more than 185,000 members in more than 170 countries and territories. The IIA serves as the internal audit profession's chief advocate, international standard-setter, and principal researcher and educator.

The IIA

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Conducting the Audit

As with all audits, there are many ways to assess executive compensation. At Community Trust Bank, the process is not conducted as a separate, stand-alone audit, but as part of multiple internal audits or review activities, according to Steven Jameson, executive vice president and chief internal audit and risk officer. "We conduct an audit of human resources, including payroll, at least every two years — sometimes sooner, if there are changes or factors in our risk assessment that suggest an audit is needed," he said. "Executive compensation and other benefits, such as stock options and restricted stock, are audited along with other employees' compensation during the periodic HR audits." The bank supplements these audits with quarterly testing and monitoring of expense reports, company credit cards, and bank account reviews for all employees, including executives.



Flexibility and adaptability are important components of an executive compensation audit process. Sometimes events entirely outside the enterprise can prompt a need to refresh an audit before its scheduled due date or to look into new data from a new vantage point. Jameson said the recent news on Wells Fargo and its issues with incentive compensation caused his bank to conduct a special review of all its incentive plans, "just to be sure we had not missed anything in previous audits." The review was in addition to assessments already being conducted around the bank's incentive plans (commercial loans, installment loans, deposits/new accounts, trust services, indirect lending, etc.).

Quick Poll Question

What is the extent of activity for your internal audit department related to executive compensation assessments?

Visit www.theiia.org/tone to answer the question and learn how others are responding.

When Audits Are Not Encouraged

While Jameson said his bank has an executive team that is very supportive of strong internal controls and tone at the top and does not resist audits of executive compensation, not all companies are so welcoming. According to Eleanor Bloxham, CEO of The Value Alliance and Corporate Governance Alliance, the reasons for resistance can be quite varied.

“Board members and audit committee members who are insecure in their roles may oppose a thorough audit,” she said. “So, too, may board members and audit committee members who are colluding with management. Or some may simply fail to appreciate their responsibility for the integrity of the executive compensation process.”

The significant risk connected with executive compensation impels internal audit to pursue a more creative approach that can generate useful results. For example, in U.S. public companies, internal audit might get the go-ahead to audit regulatory filings, such as the 10-K and/or proxy. Because these documents include various disclosures about executive compensation, internal audit may be permitted to access this information for testing.

Another opportunity could be during required annual audits of company retirement or pension plans. If external auditors are required to audit those plans and provide an opinion, there may be an opening for internal audit to engage in a support or assistance role. “I have heard of some chief audit executives (CAEs) who were able to get executive compensation audits on the schedule either by listing this area in the universe of potential audits that is shared with the audit committee or by having a private discussion with the audit committee chair, who can then request this audit,” Jameson said. He pointed out that most CAEs have an executive session with the audit committee where this potential audit can be discussed.

Another entry into executive compensation audits may be via the U.S. Sarbanes-Oxley Act of 2002. Some companies may include elements of executive compensation as key Sarbanes-Oxley controls. If so, those elements require testing to support management’s opinion about Sarbanes-Oxley controls.

Finally, various elements of executive compensation could be reviewed indirectly by auditing expense accounts in the general ledger, where executives might expense items such as entertainment, club dues, and travel.

7 Questions to Ask in Reviewing Executive Compensation Packages

Auditing an executive compensation program means asking many questions. The following sample may be useful to internal audit’s review:

- Is there a statement of objectives for the executive compensation program? Does it spell out the types of performance it is expected to motivate and the market position it is trying to achieve for executive pay? Does the actual plan support achievement of the objectives defined for the program?
- Has the company recently changed its business strategy? If so, has the executive management compensation plan been reviewed to determine if it aligns with the new strategy?
- Have any issues arisen relative to the pay plan’s flexibility or competitiveness with regard to attracting and retaining the desired talent for executive positions?
- Has compensation been properly tied to company performance factors? Are controls in place to remove management incentives to boost the numbers to achieve goals that lead to increased compensation?
- Is the compensation plan in compliance with state and federal regulations and laws?
- Does the compensation committee meet with compensation consultants in an executive session with strict confidentiality guidelines that preclude management being informed of those discussions?
- Does the compensation committee seek guidance from the audit committee, risk committee, the board as a whole, and/or other independent parties on cautionary issues surrounding risks in the plan and other issues of plan design?

The Governance Perspective

Reviewing executive compensation practices provides insight into a number of governance issues: board-level control, impact on risk (discrimination, financial statement, and other risks), and communication integrity.

Regarding board-level control, the audit should assess whether the board of directors is truly in charge of the executive compensation process. If not, executives may be involved in self-dealing — a breach of fiduciary duty. This kind of review necessitates examining the consultancy hiring process using specific questions such as: Does management prescreen a group of consultants from which the board selects? Does the board exercise judgment independent of the consultant? Bloxham said that the answer to the first question can reveal whether management is exercising undue influence over its own remuneration, and a negative answer to the second may indicate that the board is acting as a rubber stamp.



While executive compensation holds the potential for many risks, one critical risk area relates to HR and talent management objectives. Examining executive compensation calls for reviewing decision systems related to how members of the executive team are chosen and compensated. It is critical to look for signs of embedded choices regarding what is valued (such as independent thinking or personal appearance) and identify if and when those preferences cross the line into unfairness and discrimination, especially if they cause a significant impact on employee morale.

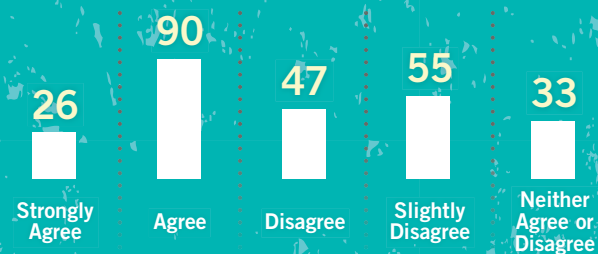
The third governance issue is communication integrity, where auditors should assess how clearly the philosophy behind the executive compensation program is articulated and the degree to which the plan mirrors that philosophy. It is important for internal and external communications to stakeholders to be accurate and consistent. For example, the wording in a proxy statement must be true and not contain conflicting or contradictory language.

It is difficult to imagine a scenario in which the probity of executive compensation would not be of great concern to the board, the audit committee, the CAE, and the internal audit function. The justification for executive compensation reviews is as straightforward as it is powerful. In Bloxham's view, it is as simple as a company's fundamental need to know that "the board is in full control, the plan and its implementation avoid unwanted risks and are consistent with the defined objectives, and communications about the plan are clear and accurate."

It is ultimately the responsibility of the CAE to build a strong relationship with the audit committee, particularly the chair, to open more doors for internal audit to do its job, including assessing executive compensation.

Quick Poll Results:

I am confident that there is sufficient assurance over compliance risk at my organization.



Based on 251 responses. Source: The IIA's *Tone at the Top* October 2016 survey.