

Dear Q&A

Would short-term and long-term incentives such as share options be appropriate for a chief audit executive, or is there potential to impact internal audit objectivity?**Answer**

There are implications for objectivity by including share options in the remuneration of internal auditors, especially a chief audit executive.

There have been numerous examples of poor behaviour amongst corporate executives caused by badly structured short-term incentive programs. Sometimes short-term incentives produce results that are not in the long-term interest of an organisation. There is also evidence that 'pay for performance' does not really work (Meyer HH, 1975. 'The Pay-For-Performance Dilemma', Compensation Review 7(3) pp 55-62. doi:10.1177/088636877500700306).

The Internal Audit Standards expect the chief audit executive to make their own judgement about matters of objectivity based on their own circumstances. The chief audit executive must be conscious of the standard categories of pressure that can impair objectivity – self-interest, self-review and intimidation. Self-interest and intimidation are clearly applicable when it comes to remuneration. Questions to ask:

- › Who is deciding whether the chief audit executive will get the incentive pay and how much is involved?
If this decision is made by the audit committee based on their own assessment of chief audit executive performance, this may be acceptable. However, this is contingent on a pre-determined structure of incentives that is not dependent on the opinion or input of line management.
- › Would short-term incentives encourage a chief audit executive to overlook behaviour that boosts short term performance at the expense of long-term health of their organisation?
Internal auditors must be conscious that, like board directors, internal auditors serve the organisation – not just current management or current owners.

Short-term incentives influenced by share price can be dangerous in any organisation, whether for management or internal auditors. Given the obvious self-interest threat, short-term performance rewards for a chief audit executive would more sensibly be confined to variable cash remuneration decided on pre-determined performance measures and specific criteria by the audit committee themselves.

It would seem there would be considerably less danger in issuing options or other securities that must be held for an extended period before being realised. This ties remuneration of the chief audit executive to organisation performance. Even here there are some matters to be considered:

- › Aligning reward with the organisation performance would be fair if the chief audit executive were demonstrably a major factor in that success. However, the linkage is likely to be more difficult to establish than it would be for operational areas.
- › Performance of a chief audit executive is highly dependent on audit committee understanding of the internal audit role. A chief audit executive whose audit committee requires internal audit to concentrate on compliance matters cannot be blamed for not addressing significant operational risks through internal audit work. Good internal audit performance requires both a professional internal audit service and a knowledgeable, informed and diligent audit committee.