

# Share incentive schemes for Chief Audit Executives

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## ABSTRACT

The use of share incentive schemes as part of the remuneration structure for the head of internal audit or the Chief Audit Executive (CAE) is one mechanism available to a company to incentivise its senior executives and to ensure they add value to the company they manage. This can however lead to challenges as internal auditors have always had to fulfil two contradictory roles: being an employee in a company and being an objective person involved in rendering independent assurance services for the same company. It is, therefore, important for internal auditors to strike the correct balance that ensures they are perceived as sufficiently independent to achieve their objectives in terms of the annual internal audit plan. Care must also be taken to ensure that the share incentives do not have a negative influence on the level (or perceived level) of independence and objectivity the CAE demonstrates.

This is the first South African study to investigate the use of share incentive schemes for CAEs. This study used structured interviews in a multiple case study approach to identify the views of the chairpersons of audit committees (CACs) on the use of share incentive schemes for their CAEs. The study found that share incentive schemes were used to incentivise CAEs mostly over the medium term. The study also found that although the CACs had little oversight over the remuneration of the CAEs, they nevertheless did consider the use of share incentive schemes to be an acceptable remuneration mechanism.

## Key words

Chief Audit Executive; objectivity and independence; share incentive schemes; incentives; internal auditors

## 1 INTRODUCTION

Share incentive schemes have recently received a lot of adverse attention in the press, especially in the banking environment. Treanor (2014) reports that Barclays paid out shares worth £32 million to its management team, despite the fact that profits were down and the share price had dropped. In South Africa share incentive schemes have also been in the limelight, with the level of the share incentives awarded to some executives being questioned. For example Shoprite's Chief Executive Officer (CEO) exercised a total of R594 million's worth of share options in 2010. This astronomical figure drew criticism as 48% of the people in South Africa at the time were living below the poverty level of R322 per month (Carte 2011).

Recognition of the importance of good corporate governance is a key aspect of business that has helped South Africa to adapt (after democratisation in 1994) to a more competitive global environment. Formal guidance on good governance practices started, in South Africa, with the *King Report on Corporate Governance (King I)* in 1994. This has evolved through a second report (*King II*), issued in 2002, to the third revision, known as the *King Code of*

*Governance for South Africa 2009 (King III)* and published by the Institute of Directors in Southern Africa (IoDSA) (IoDSA 1994, 2002, 2009). *King I* advocated an integrated approach to good governance principles, in the interest of profits for shareholders, while *King II* shifted from emphasising a single to a triple bottom line which focused on the economic, environmental and social aspects of business affecting the sustainability of the organisation (IoDSA 1994, 2002, 2009). In the *King III* report more principles were articulated that specifically recommended improved oversight by and responsibilities for the audit committee. This recommended increase in governance was endorsed by the new *Companies Act*, which strengthened the role of the Audit Committee by making it a statutory committee with legislated responsibilities (RSA 2008: section 94). The value of oversight is highlighted by Li (2010:38), who analysed the failure of Enron, and found that a lack of independent oversight over Enron's management contributed to the collapse of the company. *King III* recommends (in principle 3.7) that the "Audit Committee should be responsible for the appointment, performance assessment and dismissal of the Chief Audit Executive (CAE)", thus making oversight over share incentive schemes the responsibility of the Audit Committee (IoDSA 2009: principle 3.7).

The aim of this article then, is to explore the use of share incentive schemes as a remuneration option for CAEs. To achieve the research aim this article considers the following:

- The views of the chairpersons of the audit committees (CAC) of selected companies on using share incentive schemes as part of the remuneration of CAEs;
- The impact of share incentive schemes on the objectivity and independence of the CAE, and
- The oversight role played by the audit committees over the implementation of share incentive schemes benefitting CAEs.

A multiple case study approach was used to gather evidence from seven JSE-listed companies. According to Yin (2003:1-2), a case study is suitable when investigating a “real-life event”, like the use of share incentive schemes as a remuneration component for CAEs. A literature review on share incentive schemes for executives was pursued in order to identify key aspects of the issue, and to develop the questions used in the case studies. The questions were intended to obtain information on the use of share incentive schemes for CAEs; the impact of the share scheme on the objectivity and independence of the CAE, and the oversight role of the CAC. The literature review also considered the context within which the CAE operates by taking cognisance of the governance recommendations in the King reports (especially *King III*), and the guidance available to internal auditors that has been issued by the Institute of Internal Auditors (IIA).

The role of internal auditors is encapsulated in the IIA’s definition of internal auditing. The definition states that:

*“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes”* (IIA 2012a:4).

Given the requirement to ‘add value’ to the company, the use of share-based incentives can be as applicable to the CAE as it is to normal executives.

To achieve the aim of this article the study is broken down into the following research objectives:

- To explore the views of the CACs on the use of share incentive schemes for CAEs, taking into account the role and the position a CAE occupies in the company;
- To explore whether the CAE’s participation in the company’s share incentive schemes will influence his or her objectivity and/or independence; and
- To explore the oversight role of the Audit Committee regarding the share incentive schemes for CAEs.

This article addresses a gap in the literature on the use of share incentive schemes as part of the remuneration packages of CAEs in South Africa in that this study could not identify any existing literature that focuses on this topic. As the use of share incentive schemes for executive directors and senior executives is fairly widespread, it is likely that companies using these schemes will extend them to include the CAE. However, there is a risk that the inappropriate use of share incentive schemes could have a negative influence on the perceived independence and objectivity of the CAE, given that the internal audit function (IAF) is tasked with a key evaluation and assurance role.

Internal auditors are required by the IIA’s *International Standards for the Professional Practice of Internal Auditing* (Standards) standard number 1100 to be independent and objective. (Standard 1100 requires specifically that “The internal audit **activity** (emphasis added) must be independent, and internal auditors must be objective in performing their work” (IIA 2012b, Standard 1100)).

This is interpreted in the Standards as follows:

*“Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the CAE has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship. Threats to independence must be managed at the individual auditor, engagement, functional, and organizational levels.”* (IIA 2012b, Standard 1100.)

This interpretation is endorsed by Steward and Subramanian (2010:356), who point out that individual, and company-related issues like social pressure, economic interest and culture could impact on the CAE’s independence and objectivity. Emphasising the value of different perceptions Glover, Prawitt and Wood (2008:209) note that external auditors hold the view that outsourced IAFs have a higher degree of independence than similar in-house functions. This view should be evaluated against the findings of the iKUTU research report (completed in 2008) to understand the demands and stature of internal auditing in large listed companies in South Africa. (The report was authored by eight academics that comprised the iKUTU team - Coetzee, Barac, Erasmus, Fourie, Motubatse, Plant, Steyn & Van Staden (2010:37)). The iKUTU report found that “the Big 4 external audit firms, excluding the company’s own external auditors, are the major sources” of outsourced internal audit services (Coetzee *et al* 2010:37).

The reporting relationship, coupled with the professionalism of the internal auditor, can help reduce the risks or perceived risks that threaten the independence and objectivity of the CAE. The audit committee has an oversight responsibility over the work of the IAF, as recommended in *King III* (IoDSA 2009: principle 3.7). This oversight responsibility

extends the role of the audit committee to also consider the impact of the performance and remuneration on the CAE.

In order to address these issues, the article is structured as follows: the literature review is discussed in section 2, giving an overview of incentive schemes – and specifically share incentives – within the context of the professional environment applicable to the CAE. Section 3 explains the research methodology used to achieve the aim and objectives of the article. In section 4 the results of the interviews are summarised, analysed and discussed. In conclusion, section 5 contains a summary of the major findings and highlights areas for future research.

## 2 LITERATURE REVIEW

The literature review discusses the origin of share incentive schemes and their evolution. It then considers how different personalities react to incentives, as well as the influence of motivational theories on the spread of share incentive schemes. The results of the literature review were used to develop the interview questions, which are listed in Annexure A, and offered in an effort to encourage more extensive research on the topic.

Sections 2.1 to 2.3 describe incentive schemes, including share incentive schemes. Thereafter, in section 2.4, share incentive schemes for the CAE are discussed within the context of the professional environment applicable to internal auditors.

### 2.1 Incentives

Kraizberg, Tziner and Weisberg (2002:384) identified four different incentives that are supposed to promote work motivation and performance. The four commonly used types of incentive scheme used by companies are:

*Merit pay* – when the employees are rewarded for exceeding the predetermined levels of performance. The targets that are set for the employees are easily calculable to verify if they have been attained.

*Profit sharing* – this can be a portion of the organisation's profit, or a predetermined amount, that is distributed to the employees.

*Gain sharing* – this can be a predetermined amount that must be saved by the company in costs over a specified period. The gains, when achieved, are shared with all employees.

*Share options* – this is when the employee is offered the chance to purchase the company's shares at a predetermined future date and at a fixed price once the options are issued" (Kraizberg *et al* 2002:384).

The selection of a specific incentive scheme can depend on the objectives of the company, as well as on the assumptions in the motivational theory used to incentivise employees. Kraizberg *et al* (2002:384) link motivational incentives that encourage increased work efficiency to two management theories, namely the expectancy theory and the equity theory.

Lunenburg (2011:1) notes that the "expectancy theory is a cognitive process theory of motivation that is based on the idea that people believe there are relationships between the effort they put forth at work, the performance they achieve from that effort, and the rewards they receive from their effort and performance". Thus, the expectancy theory suggests people are motivated by their conscious expectations of what will happen if they behave in a certain way or do certain things. Pappas and Flaherty (2006) describe expectancy theory as remuneration that is linked to motivation, and say that the rewards must be aligned to the individuals' values. Merit pay, profit-sharing and gain-sharing support to a varying degree the concept that there is a link between behaviour and expected rewards, and can be used as mechanisms to motivate employees in the context of the expectancy theory. Share incentive schemes, in terms of the expectancy theory, generate lower levels of motivation and performance. This is because company performance is dependent, to a degree, on market forces which are outside the control of the individual employee. Kraizberg *et al* (2002:386) note that share incentive schemes are for those managers who are incentivised by a sense of ownership. This is also in line with the equity theory, which is about fair remuneration of employees based on their individual values. According to Bell and Martin (2012:111), equity theory is about employees believing that they are treated equally and fairly, and that management objectively treats those who are in the same position in the same way.

Over and above the motivational theories, the personalities of the individuals involved can also play a role. Furnham (2003:326) cites Gray's theory, which states that people who are extroverts respond very positively to rewards while introverts react when there is a threat or implied punishment (Furnham is alluding here to the challenges implicit in the use of a standardised incentive scheme).

The use of incentives is important: Wowak and Hambrick (2010:818) found that executives' personality characteristics and incentives do affect the company's results. Share incentive schemes are by their nature more suitable for employees who have overall responsibility for the wellbeing of the company, because they are in the best position to increase the value of the company as they enter into an arm's-length contract with the board (Bebchuk & Fried 2005:11). Company executives could include the (CEO), chief operational officer (COO), chief financial officer (CFO), chief information officer (CIO) and business unit heads. The chief risk Officer (CRO) and CAE can also be included in this list, as they are responsible for managing the risk and assessing the adequacy of the risk, control and governance processes respectively.

These executives usually have short-, medium- and long-term objectives that are aligned to the company's objectives. Share incentive schemes are a method of remuneration that can be used as an incentive to ensure the personal goals of these executives remain aligned with the company's objectives, thus ensuring that value is added to the company.

## 2.2 Share incentives

Barclays (in the UK), and Shoprite (in South Africa) are two of the relatively few listed companies that have received bad publicity in the past regarding their share incentive schemes (Treanor 2014; Carte 2011). This criticism highlights the risk that share incentive schemes can be considered too generous. Jensen, Murphy and Wruck (2004:57), who are also critics of share-based incentive schemes, are of the view that these yield excessive levels of compensation for the executives. These high levels of compensation can be likened to value destruction. The reason for the negative view of share incentive schemes is that the executives are not required to buy the shares or

reduce their pay package/bonuses to be able to purchase the stock (Holden 2005:142). Therefore the executives could see the share allocation simply as (usually deferred) additional remuneration which tends to reduce their alignment to the company's objectives.

Another example of the risk posed by excessive share-based remuneration is demonstrated by the Enron affair. Healy and Palepu (2003:4) explain that Enron used an aggressive recruitment strategy with generous offers of money and shares as the main motivation for employees; this strategy focused on short-term goals. In 2000 and 2001 the Chairman and CEO of Enron were awarded compensation as shown in Table 1:

**Table 1: Compensation paid to the Chairman and CEO of Enron**

	Total compensation	Salary	Bonuses	Restricted stocks	Stock options	Other benefits
Chairman	\$18.2 m	\$1.3 m	\$7 m	\$7.5 m	\$0.8 m	\$0.38 m
CEO	\$10.9 m	\$0.85 m	\$5.6 m	\$3.5 m	\$0.87 m	\$0.05 m

Source: Healey & Palepu (2003)

Although it is good to take into account motivational theories and the personality profiles and preferences of individuals when developing incentive schemes, it might nevertheless be impractical for companies to effectively implement employee-specific incentive schemes. In addition, customised schemes could be demotivating when employees are motivated by the equity theory. Incentives, as part of the remuneration for employees and managers, are generally determined by the company and are therefore generic to the position, rather than specific to the person. The remuneration policy and practices fall under the oversight of the remuneration committee (REMCO), a board committee. *King III* recommends that the "remuneration committee should assist the board in its responsibility for setting and administering remuneration policies in the company's long-term interests for all levels in the company, but should be especially concerned with the remuneration of senior executives" (IoDSA 2009: principle 2.25). Similarly, it would be difficult for a company to approve an executive share-incentive scheme that would exclude some executives like the CAE – based simply on the assurance role fulfilled by the internal auditors – without a compelling professional reason, such as managing a threat to the independence and objectivity of the CAE. However, as internal auditors are professional people who are guided by a code of ethics, their professionalism should counteract threats to their objectivity, and the reporting relationship with the audit committee adds a further level of safeguards to protect their independence.

In the next sections the value of and risks applicable to share incentive schemes in general are highlighted, as these could also identify potential adverse impacts on the company should share incentive schemes be used to incentivise the CAE.

## 2.3 The value of and risks posed by share incentive schemes

According to Holden (2005:135) the original share incentive schemes were introduced by Du Pont and

General Motors. These early share incentive plans gave the company's management exposure to risks and rewards in a way that was similar to that of shareholders, and were more long-term in nature (between seven to 10 years). The companies lent the managers money to buy the shares at market price and interest was charged on the loan amount granted (Holden 2005:135).

The characteristics of the Du Pont and General Motors schemes were as follows:

- The schemes provided the executives with participation in equity incentives that offered them risks and reward.
- The bonuses received by managers were partially used to pay off the debt.
- The dividends were received through the trust as a way of paying the debt (Holden 2005:138).

Holden (2005:142) criticises current share-based incentives because exposure to the risk part of the equation has been removed and the focus is now only on the reward for the company's executives. Lehmann and Hoffman (2010:71) mention that the banking and insurance crisis was a result of inadequate risk management processes. There was no proper accounting for the risk underlying the transactions. The current share incentive schemes make the executives focus on short term share price increases, without taking the company's overall and long-term performance into account. This could result in value destruction, due to short-term performance being achieved to the detriment of the long-term sustainability and business objectives. This view is supported by Smith and Nel (2010:12), who argue that the current executive incentive structures are geared to reward short-term risk-taking. There seems to be no assessment of these decisions in the long term to ensure that the company value is being maintained. *King III* (IoDSA 2009) contains principle 2.25 which focuses on fair and responsible

compensation that is meant to enhance the shareholder value in the short, medium and long term.

Shortcomings of the current schemes can be summarised as follows:

- The scheme rules prescribe that the options are not worth anything until they exceed the exercise price. In these instances management is encouraged to take excessive risks to ensure that the shares appreciate (Hall and Knox 2004:403).
- The dividend policy that is adopted by management can encourage over-retention of earnings, as the holders of share options do not qualify to receive dividends (Hall and Murphy 2003:20).
- When the share options' actual price falls below the exercise price the options are either cancelled or reset. This means that the manager's specific share options are worthless and in many cases they are replaced by a new allocation (Holden 2005:142).
- The current share options' vesting periods are shorter and therefore management ends up focusing on the short-term rather than on the long-term performance of the shares (Holden 2005:142).
- It is sometimes difficult for some senior management to accept share incentive schemes instead of bonuses, as they believe that they only have responsibility for and control over specific and narrowly defined areas in the organisation (Holden 2005:142).
- The critics of share incentive schemes believe that this type of incentive has been implemented as an additional benefit for executives. The share options are in most instances granted to the executives without them being required to pay fair value for the shares being awarded (Holden 2005:142).

Share incentive schemes for executives are most powerful in periods of rising market conditions. In addition, the schemes are open to the criticism that executives are being granted short-term share incentives without having to put up any personal finance. These situations can result in management focusing on short-term gains to the detriment of the medium- to long-term objectives of the company, simply in order to achieve the personal benefits arising from short-term share incentives (Holden 2005:142.).

Bhengu and Bussin (2012:90) conducted a study that indicated that share options are regarded as an important reward mechanism and part of talent management. However, the results of the survey also indicated that employees prefer rewards that are linked to individual performance (Bhengu & Bussin 2012:90). This is in line with the findings of Blair and Beer (2006:19) that share-based incentive schemes should address staff retention and must have performance hurdles.

To address the risks of an inappropriate incentive there should be an executive management remuneration policy that covers the incentives, including participation in share incentive schemes, and this should detail the criteria for participation and the objectives that must be met in order to earn and redeem the shares.

#### 2.4 Share incentives for internal audit

According to PricewaterhouseCoopers (PwC 2010:8) the CAE needs to possess a strategic understanding that is employed to protect the business and to deliver value to the key stakeholders such as management and the audit committee. Given the requirement in the IIA's definition of internal auditing, that the function adds value, this strategic understanding can be the key to ensuring that the IAF fulfils the mandate set by the definition. In addition to the requirements set out in the definition of internal auditing, the members of the Institute of Internal Auditors (IIA), as professionals, are required to abide by the requirements of the Institute's code of ethics and its published Standards.

The specific responsibilities for the IAF, as recommended in *King III*, have raised the profile of the internal audit profession (IoDSA 2009: principles 7.1, 7.2 & 7.3). The question should therefore be asked: will share incentive schemes negatively impact the perceived professionalism of the CAEs? According to Denis, Hanouna and Sarin (2006:486), share incentive schemes can encourage people to participate in fraudulent activities if there is no oversight by the board.

The IIA's Standard 1110 guides internal auditors with regard to their independence and objectivity, stating that internal auditors must report potential situations that could impair their independence and objectivity (IIA 2012b). According to the IIA's Incentive Pay Survey (IIA 2004), there are disadvantages to participating in share-based incentives that are based on company performance. A few respondents to this survey believed this could impair the objectivity of the internal auditor and furthermore, damage the perceived independence of the IAF (IIA 2004). According to Holt (2012:891) there was a perception by investors that the trustworthiness of the disclosure was improved when the CAE reported to the audit committee functionally, and to the CEO administratively. IAFs that report to the CFO were perceived to be less independent and therefore more easily influenced by management (Holt 2012:891). Dickins and O'Reilly (2009:19) performed a study investigating the independence of the IAF which focused on the correlation between CAE reporting lines and annual remuneration reviews. The study revealed that only 51% of the CAEs' had a primary reporting line to the audit committee, while 31% reported primarily to the CFO, and 12% reported to the CEO (Dickins & O'Reilly 2009:19). The research demonstrated a link between perceived independence and the reporting lines of the IAF.

Dezoort, Houston and Reisch (2000:45) conducted a survey that found that 23% of the internal auditors

surveyed received share incentives or a combination of cash and shares as incentives. The internal audit department in most instances is subject to the same compensation plans as other employees in the company. The respondents also believed that internal audit productivity and effectiveness increases when they participate in incentive-based compensation (Dezoort, Houston & Reisch 2000:45). Hanafi and Steward (2015:48) confirmed during their recent study that internal auditors do receive incentive based compensation. The incentive based compensation should ideally be linked to the non-financial key performance indicators of the organisation, such as the internal audit department's value add and levels of its clients' satisfaction.

Schneider (2003:494) indicates that share incentives did not affect the internal auditors' reporting decisions, as internal auditors viewed shares as long-term incentives that did not impact their reporting. The Chartered Institute of Internal Auditors (CIIA 2013) supports the idea that the CAE's remuneration should be designed in a manner that prevents potential conflicts of interest. As it would be difficult for the CAE to influence the medium- to long-term performance of the company by consistently failing to report irregularities discovered during a risk-based internal audit, medium- to long-term share-based incentives should not have an adverse impact on the objectivity or independence of the CAE.

*King III* (IoDSA 2009: principle 2.25), in referring the determination of remuneration to REMCO, includes 'executives', which is wide enough a definition to include the CAEs. This would ensure that there is independent monitoring and approval of these types of share incentive schemes should they also be granted to the CAE. This can be further strengthened by adding claw-back provisions. A claw-back provision is a special contractual clause that is sometimes included in the employment contract that deals with benefits that can be taken back under specific circumstances. The Financial Reporting Council (2014) has revised the UK Corporate Governance Codes and has included a provision to include claw-backs on variable pay in the event of discovery of misstatements or misconduct. Claw-back provisions are something that the audit committee can consider for inclusion in the CAE's performance contract, thus ensuring that variable remuneration packages implement best practices. Deloitte (2014:3) is of the view that the audit committee needs to play a strategic review role and to benchmark the remuneration package applicable to the CAE.

The literature review considered the different incentives for employees, but with particular focus on executive share incentive schemes. This type of incentive has been criticised as it is perceived to focus on enhancing the short term performance of the company. The interviews and research quoted focused on the status of the IAF and the share incentive schemes for CAEs. This was undertaken to establish whether the CAE's participation in share incentive schemes could damage the perceived independence of the IAF and the objectivity of the CAE. More detail on the research methodology

followed to achieve the aim of this study is presented in the next section.

### 3 RESEARCH METHODOLOGY

This article reports on the use of exploratory research conducted in a multiple case study framework, focusing on seven companies, as the individual case studies, to achieve the research objectives. Page and Meyer (2003:22) describe an exploratory study as an exploration of a problem. The study being reported here was limited to South African companies, as the seven companies selected are all listed on the main board of the Johannesburg Stock Exchange (JSE). Data was collected from the chairpersons of the audit committees using structured interviews. A qualitative methodology was followed, using a positivistic perspective to analyse the data from the interviews. A positivistic perspective is valuable in this case as it "assume[s] that reality is objectively given and can be described by measurable properties which are independent of the observer" (Myers 1997). Gordon (2011:6) indicates that qualitative research is about how an individual and/or groups reason on certain issues: in this instance the issue was the use of share incentive schemes as part of the remuneration of the CAE. It was seen as important to interview the chairpersons of the audit committees, as they are the most influential people in a company's audit universe, given their oversight role over the internal audit function and the CAE. The company's board delegates governance responsibilities to the audit committee under the leadership of the chairperson. Turney and Zaman (2007:25) indicate in their research that audit committees have a significant influence over management and the various assurance providers, including the IAF. The audit committee members and the culture of the company could therefore influence the governance process. Thus, audit committees that fulfil their governance responsibilities have a greater chance of ensuring that their companies implement and apply effective governance principles. The next sections provide more detail on the companies selected for study (section 3.1), and the data collection process (section 3.2).

#### 3.1 Case study

The target population was large companies from multiple industries that are listed on the JSE. The companies selected were all listed on the main stock exchange at the time the interviews were conducted, and are perceived to be strong and influential companies in their sectors. Purposive sampling was used and considered the size of the companies, and the industries in which they operated, as well as whether the researchers could gain access to the CACs. The market capitalisation of the participating companies ranged from R440 billion to R3 billion, with a combined total market capitalisation of approximately R550 billion on 1 November 2014. For the purpose of confidentiality, the seven companies are presented anonymously as companies A to G.

#### 3.2 Data collection

Data was collected from the participants (CACs & selected CAEs) using a structured interview template,

designed to address issues identified in the literature review reported above. The questions were open-ended, in order to allow the participants maximum opportunity to express their views. Participants were also specifically asked if their company's policy with regard to the participation of the CAE in an incentivised share scheme differed from their own personal views.

The interviews with the CACs were recorded to ensure that important information was not omitted, lost or overlooked. In order to validate the information collected, the responses were transcribed and e-mailed to the interviewee for approval prior to the data analysis.

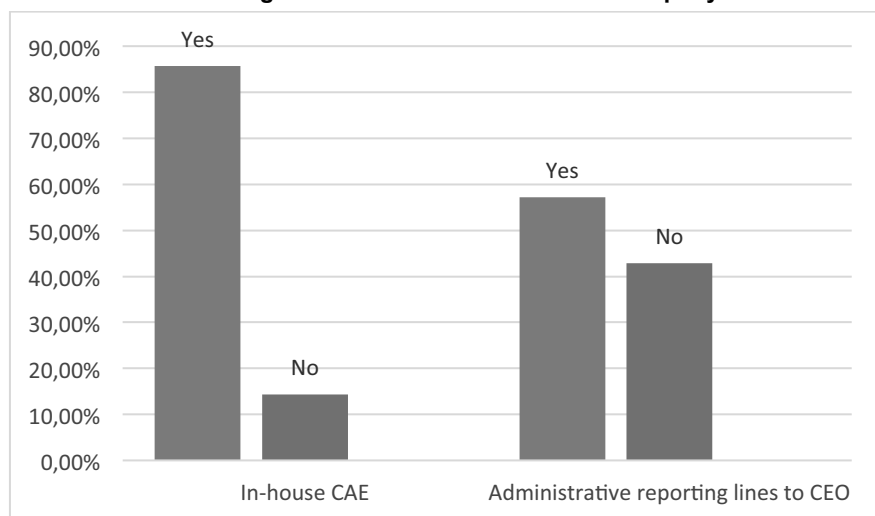
The interviews were conducted with six chairpersons of audit committees who represented the seven companies, as one person was chairperson for two companies. The questions were sent to the participants prior to the meetings to ensure that they would be adequately prepared for the interviews. Remuneration information was also gathered from the 2013 integrated annual reports of the participating companies and verified during the interviews.

#### 4 RESULTS AND DISCUSSION

Of the seven companies, six had in-house CAEs who were participants in their companies' incentivised

##### 4.1 Status of the IAF in the company

Figure 1: Status of the IAF in the company



From the information in Figure 1 it is evident that 86% (n=6) of the companies have in-house IAFs headed by CAEs. One company outsourced its IAF to an internal audit service provider. The CAE's role was also fulfilled by the service provider. The iKUTU research report shows similarly limited use of outsourcing by large listed companies, recording that 86.6% used an in-house or co-sourced IAF (Coetzee *et al* 2010: 21). The company in this study that uses a fully outsourced IAF represented only 13.4% (n=1) of the functions surveyed.

Although this is not shown in Figure 1, all of the CAEs reported functionally to their company's CAC. The

share schemes, while the seventh company made use of an outsourced provider for its internal audit services. The CAE of the outsourced IAF was deemed ineligible to participate in the company's share scheme. The profiles of the six participating CAEs showed that they had been, or were currently executives of their companies. All had obtained Chartered Accountant (South Africa) professional qualifications (CA(SA)). As CA(SA)s they are obliged to ensure that remuneration received as part of an incentive scheme is in line with the requirements of ET 102 section 340 (SAICA student Handbook 2014/2015 III). The average age of the CACs who were interviewed was 62 years. In addition, the average duration of their tenure as the chairpersons of their companies' boards' audit committees was 6.5 years, and ranged from two to 12 years. One of the six in-house CAEs did not participate in a share incentive scheme; nevertheless he/she was also interviewed to obtain his or her views on the use of share incentives. Similarly, the CAE of the outsourced IAF was interviewed to obtain his or her views on three of the research themes that relate to share incentives for an in-house CAE. The information gathered during the interviews was sub-divided into three main themes, as will be discussed in sections 4.1, 4.2 and 4.3 below.

IAFs were thus compliant with Standard 1110 – organisational independence (IIA 2012b), and *King III's* recommended practice 7.4.4, which recommends that the function reports functionally to the audit committee (IoDSA 2009). Thus, the actual reporting lines used enable the CAE to operate within the independence parameters recommended by the IIA.

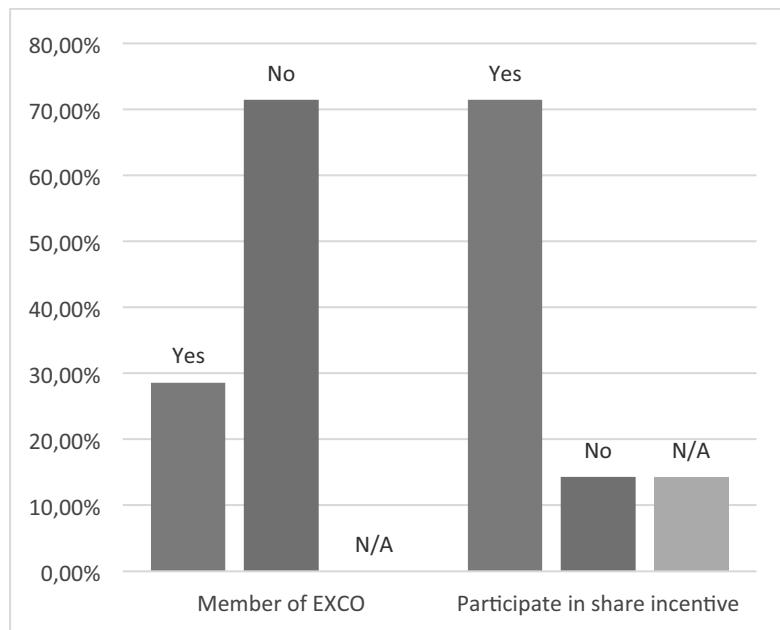
The administrative reporting lines were split almost equally: 57% (n=4) reported to the CEOs and 43% (n=3) to the CFOs of their respective companies. The three instances where the CAEs reported to the CFOs were justified by the CACs, the situation being considered suitable given the way these businesses

were set up. These were divisions/entities that were supported by the central shared services, which included internal audit. The iKUTU research report identified more favourable functional reporting lines, in that 83% of the CAEs reporting functionally to the CAC (Coetzee *et al* 2010:19).

Standard 1110 – organisational independence – does not prescribe the operational reporting lines, but does say that the CAE *should* report to someone at a level

that could assist the IAF to fulfil its responsibilities (IIA 2012b). It is therefore important for the independence of the IAF that it have a strong and effective functional reporting line to the CAC and an operational reporting line to the CEO or any other person approved by the audit committee. *King III* requires companies to ‘apply or explain’ how its principles and recommendations have been applied or not applied (IoDSA 2009:6).

**Figure 2: Status of the IAF/CAE within the company**



As shown in Figure 2, over 70% (n=5) of the CAEs were not formally part of their company’s executive committees (EXCO). Membership of the EXCO was the prerogative of the CEO. The CACs indicated that the excluded CAEs did still participate, as invitees, called on from time to time to present audit items at EXCO meetings, and also attended other governance forums of their companies. There was consensus that sitting on EXCO is not only about the position one held within the company; as two CACs mentioned, the “CAE must have the right gravitas and attitude to be part of the executive team”.

According to the CIIA (2013), the CAE should participate at EXCO level to give the person the appropriate standing within the company; so that she/he has ready access to decision-makers, and thus the proper authority to professionally challenge executive decisions when necessary. Although in this study only 30% (n=2) of the CAEs were members of EXCO, it is a practice that other companies should consider implementing. The CAE can be a permanent invitee of EXCO (thus entitled to contribute, but without the right to vote on operational issues), which would maintain the independence of the function and his or her objectivity, while still having formal and unhindered access to the company’s executives.

In addition, Figure 2 shows that 70% (n=5) of the CAEs participated in their companies’ share incentive schemes. Only the company that has outsourced its

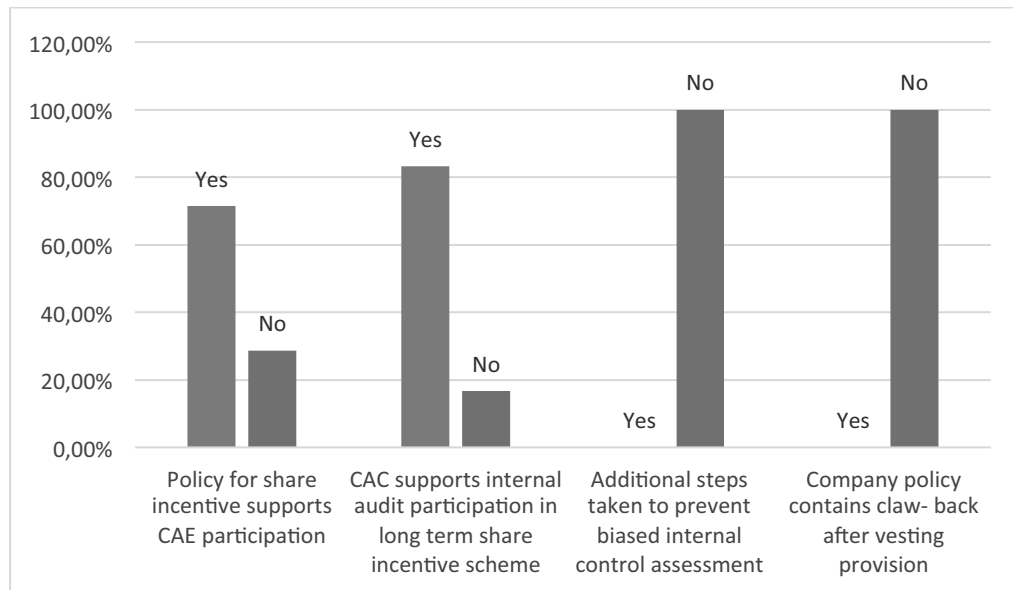
IAF to an independent service provider does not use share incentives as part of CAE remuneration, as their fees are contractually fixed. According to the CAE of the outsourced IAF: “The staff is not allowed to buy shares of the client companies. This practice extends to the internal audit outsourced function. This is part of the professional business independence rules”.

Outsourcing tends to mitigate the perceived risk to independence, as the CAE does not participate in client share incentive schemes. This comment is consistent with the findings of Glover, Prawitt and Wood (2008:209), whose research confirmed that external auditors are willing to rely on outsourced internal auditors because they perceive them to be more independent than an in-house function.

**4.2 Company share incentive schemes and acceptance by the Audit Committee**

As shown in Figure 3, participation by the CAE in share incentive schemes was permitted in terms of company policy for 70% (n=5) of the respondents, and prohibited for 30% (n=2). Figure 3 also shows that six CACs (representing about 83% (n=5) of the participants), did not believe that the participation of the CAEs in long-term share incentives could impair their objectivity, as long as the allocation was more heavily weighted towards individual and departmental contribution to company successes.



**Figure 3: Company share incentive schemes and acceptance by the Audit Committee**

Some of the views of the CACs who support CAE participation in share incentives are quoted below:

- “Participation of senior employees in share incentive schemes does aid the company in attracting and retaining senior employees”;
- “It is important to want him or her to be part of the team – very important. If the individual is too “independent” it can cause lack of trust. The CAE should be treated as an executive based on the levels agreed by the company”;
- “It is to the benefit of the company to include the CAE in the long-term share incentive if he or she is improving the control environment in the company”, and
- “The CAE does not have decision-making authority and does not have control over the transactions processed by the company”.

According to the CACs, internal audit is only one element of the control framework; they also rely on other assurance providers for internal control assessments. The external auditors and other assurance providers play a role in the validation of the internal financial control written statement that is attributed to the CAE, while proper governance structures and the board play an oversight role over the executives.

According to the CACs, failure by the CAEs to conduct their work in a professional manner could have a negative impact on their individual reputations, should the CAE be dismissed due to misconduct. A CAE who is dismissed from an IAF might subsequently struggle to find other professional employment.

Although the professional qualifications of the CAEs were not requested during this research, the iKUTU report revealed that 76% of CAEs of large listed companies are either Chartered Accountants (holding

the (CA(SA) qualification) or Certified Internal Auditors (holding the CIA designation) (Coetzee *et al* 2010:20).

The views expressed against CAE participation in share incentive schemes revolved around the independence that could be impaired. As one of the CACs said: “this individual should be completely independent and should not hold shares in the company, similar to the external auditors”.

We can draw the conclusion from the above that for some interviewees, internal auditors should be treated similarly to independent non-executive directors of companies, or external auditors. The CAE must therefore not have connections that may lead to any kind of conflict of interest in the future. The view against participating in share incentive schemes was unexpected. It can be argued that the dissenting CAC demands an exceptionally high level of independence from his/her IAF. The views of this CAC could also have been informed by his/her external audit background and the recommendations in this regard from the UK’s financial services sector, with which he/she is familiar. (The CIIA (2013:9) recommends that CAE remuneration be structured in such a way as to avoid conflict of interest.)

According to the CACs, none of the companies’ long-term share incentive schemes have claw-back clauses. The possibility of having claw-backs is something that can be implemented in the company’s remuneration policy, with specific criteria for claw-backs being defined for participating CAEs by the audit and remuneration committees, as this would mitigate many of the concerns of possible conflict of interest.

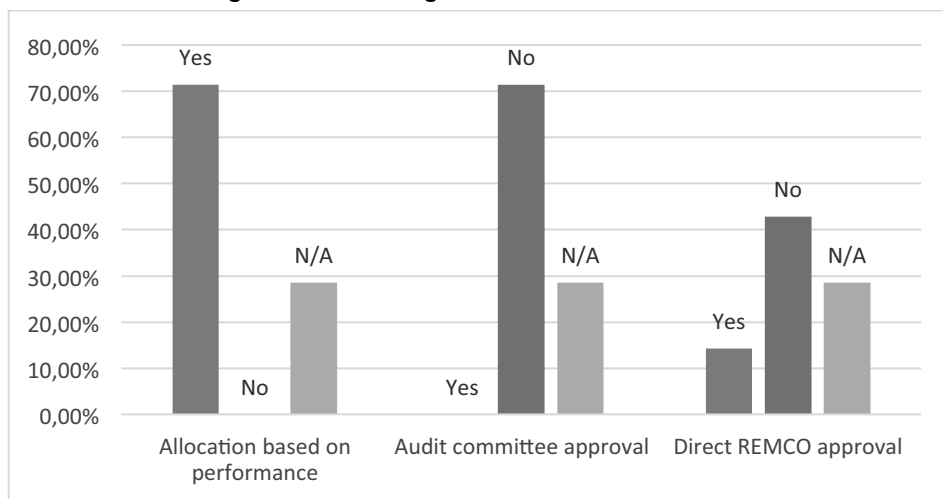
#### 4.3 Monitoring of the CAE share incentive

Figure 4 illustrates that 70% (n=5) of the CAEs believe that individual or departmental performance plays a big role in the allocation of their long-term share incentives. The performance assessments of

the CAEs were undertaken by management with additional, informal input being requested from the audit committee. The CACs do not get to review or approve the share incentive scheme allocations to the CAE either for appropriateness or fairness. This is an

area that could be improved by having the audit committee review the remuneration structure and results of the performance management assessment of the CAE annually.

**Figure 4: Monitoring of the CAE share incentive**



In Figure 4 only one CAE's remuneration was referred to REMCO for review based on this specific sub-committee's mandate. In the other instances the CEO

or CFO would allocate shares and bonuses to the CAE and other senior employees based on the guidelines provided by REMCO.

**Figure 5: Number of years before full vesting**

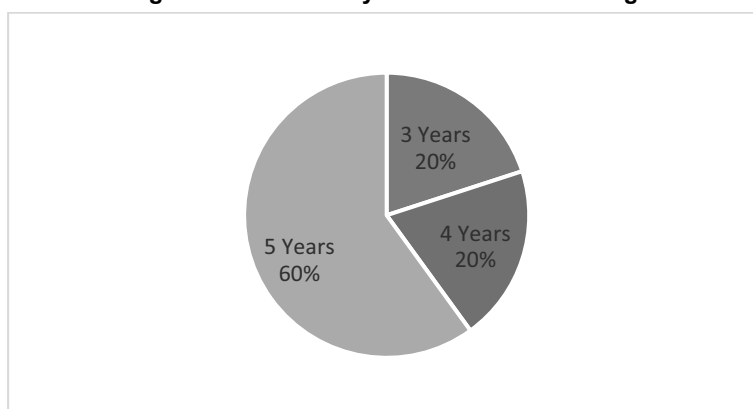


Figure 5 illustrates the vesting policies of the five companies whose CAEs participate in the companies' share incentive schemes. One company (n=1 (20%)) had a full vesting of shares after three years, and another had full vesting after four years (n=1). The

other three companies (60%) have full vesting after five years. The tranches set out in Table 2 explain the delayed vesting periods, and are used to ensure that high-quality performance continues in the medium term.

**Table 2: Share vesting periods**

Company	No. of years before vesting	Tranches percentage vesting
A	2 to 5	20% in year 2, 20% in year 3, 30% in years 4 and 5.
B	3 to 5	Shares can fully vest anytime between 3 and 5 years.
C	3	Shares vests in full by end of year 3.
D	3 to 5	33.3 % in year 3, year 4 and year 5.
E	3 to 4	50% in third year and 50% in fourth year.

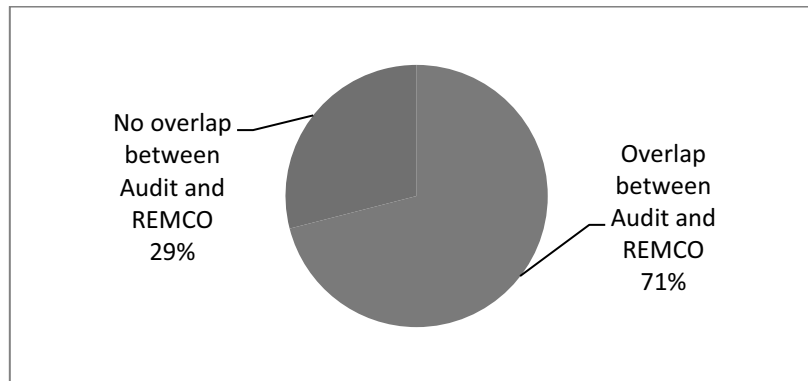
The schemes above can be seen as medium-term incentive schemes, as the shortest vesting period is two years after issue of the shares (company A). The other three companies' share incentives begin vesting

in tranches from year 3 (as indicated in Table 2), and full vesting is attained between three and five years from issue. It is possible for the CAE (or any executive for that matter) to hide wrongdoing from the

audit committee and thereby gain financially in the short term; however, it would be very much more difficult to hide errors/wrongdoing for a longer period. Thus, the use of longer vesting periods would appear

to address some of the objections raised to the use of short-term share incentive schemes as a remuneration mechanism.

**Figure 6: Cross-membership between committees**



The cross-membership between the audit committee and REMCO was assessed in the participating companies. As illustrated in Figure 6, in 71% (n=5) of the companies there is overlapping membership between the audit and remuneration committees. This could be seen as a best practice in that it should ensure that audit-related issues are given prominence at REMCO and vice versa. Chandar, Chang and Zheng (2012:161) found that it was beneficial for the company to have overlapping memberships between the audit and remuneration committees. The CACs who are also members of REMCO are thus better able to assess the fairness of the overall remuneration of the CAE. Furthermore, the IoDSA (2009: principle 3.7) gives the audit committee the responsibility of ensuring the performance assessments and possible dismissal of the CAE are conducted fairly.

## 5 CONCLUSION AND RECOMMENDATIONS

The CAE plays an important role in evaluating and assuring the adequacy and effectiveness of the risk, control and governance processes of the company in order to add value to the company. The study found that most of the CACs did not believe that participation in their companies' share incentive schemes would influence the assurance opinion that is received from the CAEs. This is because the reporting lines help to ensure the independence of the CAE, and the professional requirements subscribed to by the CAEs, linked to the reputational risk posed by non-professional conduct, protect the CAE's objectivity. In addition, the use of combined assurance, where other assurance providers table reports on common events and processes help the audit committee to validate the findings of the IAF.

There is consensus amongst the majority of the CACs that the participation of the CAE in medium- to long-term share incentive schemes can be good for the company as well as for the individual CAE.

The participating companies had medium-term share incentive schemes that fully vest after a minimum of three years, or in tranches extending from 20% in year 2 until completion in year 5. Where tranches vest

a minimum three years from allocation, this can positively contribute to the CAE's long-term outlook and value creation.

The audit committee was found to have a weak oversight role over CAE remuneration. The CAEs' performance management and remuneration was handled by the CEO or CFO, because it was understood to be an administrative responsibility. The CACs did not formally approve the remuneration of the CAEs despite this being required by the *King III* principles. Despite the IoDSA (2009: principle 3.7) identifying the audit committee as being responsible for the appointment, performance assessment and dismissal of the CAE, this might be a function that could still be practically difficult for the audit committee to perform. Future research could be done to assess whether the audit committees are practically able to fulfil the responsibilities of appointing, conducting performance assessments and dismissing the CAEs. The monitoring mechanism of the CAE's performance and remuneration can be improved either by having the role referred to REMCO, or by requiring the audit committee to formally approve the CAE's remuneration as one of the audit committee's year-end duties.

This article has certain limitations. The population comprised only seven JSE-listed companies, drawn from multiple business sectors. In addition, only the chairpersons of the audit committees were interviewed, and unlisted companies and public sector entities were excluded from the study. Therefore, the results cannot automatically be assumed to apply to all (or even any) other companies. Despite these limitations, the research uncovered well-articulated perceptions about the impact of share incentive schemes on the independence and objectivity of the CAEs. It is therefore recommended that future research be expanded to study more listed companies, and/or unlisted and public-sector organisations, assessing the roles of audit committees in the implementation of the *King III* principles in regard to the appointment, performance assessment, incentivising and dismissal of the CAEs.

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## ANNEXURE A

The questions that were posed to the CAC were as follows:

- What is the standing of the internal audit department in the organisation (mandate, reporting lines, stature of the IAF within the Group)
- How is the CAE's salary structured in terms incentives, this is in comparison with other Executives at the same level? (this refers to the employee grade)
- Does the CAE participate in share based incentives (short or long term incentives)?
- If no, what are the alternative incentives structures that are implemented to ensure that the key audit staff members are retained by the organisation?
- How does the audit committee ensure that the CAE does not unduly benefit from short term increase in share price that is achieved at the expense of long term value destruction?
- In the year that the shares vest, does the Audit committee implement additional steps to ensure that the CAE does not become bias in his/her assessment of internal financial controls?
- Does the company have policy that supports the participation of the CAE in the company share incentive scheme?
- In the event of wrongdoing being established against the CAE after the shares have vested. Are there claw backs clauses in the contract or policy?
- Do you believe it will be beneficial if the remuneration of the CAE is referred to Remuneration Committee for approval?

