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OECD Corporate Affairs Division
Response e-mailed to: lya.villasuso@oecd.org

RE: Corporate Governance and the Financial Crises

Dear Sir/Madam:

Attached is The Institute of Internal Auditors' response to the OECD's consultation on Corporate Governance and the Financial Crisis.

The Institute of Internal Auditors (IIA) welcomes the opportunity to respond to the OECD's consultation on Corporate Governance and the Financial Crises. Our comments are based on a thorough analysis and discussion, utilizing a core team of audit experts who serve on the Institute of Internal Auditors' Professional Issues Committee.

We commend the OECD for its plans to address weaknesses in corporate governance that are related to the financial crises and seeking input on:

- The role of corporate governance in the financial crises;
- Identifying the most urgent areas of reform;
- How OECD can improve and support implementation of agreed standards; and
- How OECD can support national, regional, and global initiatives.

Overall, we believe there is a need for robust risk management efforts in companies, attestations by management as to their effectiveness, and assessment by internal audit of their proper functioning. Our responses to the specific issues for consultation can be found in Attachment A.

The IIA welcomes the opportunity to discuss any and all of these recommendations with you. We offer our assistance to the OECD in the continued development of an appropriate framework. We thank you in advance for considering our comments. Should you have any questions or need any additional information do not hesitate to contact me.

Best Regards,

Richard F. Chambers, CIA

About The Institute of Internal Auditors
The IIA is the global voice, acknowledged leader, principal educator, and recognized authority of the internal audit profession and maintains the *International Standards for the Professional Practice of Internal Auditing (Standards)*. These principles-based standards are recognized globally and are available in 29 languages. The IIA represents more than 150,000 members across the globe, and has 99 affiliates in 165 countries that serve members at the local level.

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Attachment A
Institute of Internal Auditors (IIA)
Response to OECD Consultation on Corporate Governance and the Financial Crises

Governance of Remuneration

1. ***What are the most important features of a well governed process for deciding on compensation in a company? Which should be the role of shareholders in this process?***

   The board must remain responsible and accountable to shareholders for the governance of the organization in all respects, including the design and execution of any compensation scheme. Transparency, consistency, economy, market-conformity, and fairness are the most important features. The compensation process should start as one of the outcomes of the mission statement of the company. Guiding principles should be introduced and/or reinforced with a focus on ensuring that compensation plans do not encourage achievement of short term measures at the expense of longer term shareholder value through excessive risk taking, or other means.
   The compensation system should be designed to encourage appropriate behaviors that are aligned with the long-term strategies, goals, and best interests of the organization. Variable pay should be tied to long-term strategies and their achievement. The compensation program has to be balanced with prompt action when individual performance and organizational achievement fall short.
   The board should disclose to shareholders the process they follow, who their advisors are and why they are independent, and how the process ensures compensation is aligned to long-term strategies and objectives and in the best interests of the organization. The board should remain accountable to the shareholders for the quality of their governance.

2. ***What are the main risks associated with performance based compensation? How can they be identified and taken into account?***

   The main risks associated with performance based compensation include:
   - Encouragement of behavior inconsistent with the long-term interests, strategies, mission, and goals of the organization.
   - Reward of short term achievements which are not in the best interests of the long term success of the organization.
   - A focus by management on the measures that are defined and rewarded to the exclusion of those which are not.
   - Large awards may result in inappropriate inequities among groups or levels of employees, inconsistent with their contribution to the success of the enterprise, and that public perception is of inappropriate compensation.
   - Performance targets creating an attitude of inflexibility to the employees.

   These risks can be partially mitigated by avoiding performance measures that are solely mechanical exercises. Performance measures must be used within a broader assessment of performance including the exercise of judgment.

3. Should risk managers and the boards' risk management function be formally involved in the design of compensation schemes?

Any key risk area should be subject to risk review, ideally by a function which is independent of the area being reviewed. However, it is not necessary for the risk management function to be involved in the design of compensation schemes as long as they can be assured that related risks are identified, assessed, and appropriate actions taken. The risk managers cannot be experts in the operational details of every area where there is risk. However, they should be sufficiently knowledgeable and involved to ensure the risks are addressed.

Implementation of Risk Management

4. What is the most important step a company can take if it wants to improve its risk- management system?

Obtaining an independent, objective assessment of the risk management processes would be invaluable. The company should look first to its internal auditor to perform this assessment. If the internal auditor is unable to complete the assessment (for example the resources are not available for such an assignment), an external agency should be engaged to perform the work at the direction of the internal auditor.

Additionally, the CEO should be required to report to the Board on a periodic basis that the risk management framework has been designed and is operating in a manner that ensures that all material risks can be identified, assessed, and acted upon. Internal audit – having direct access to the board – can provide independent assurance that these statements are correct. Steps to improve risk management should be approved/reviewed and monitored by the board.

5. How shall the internal governance structure be designed to support active and effective implementation of risk-management throughout the company?

In designing the internal governance structure to support active and effective implementation of risk-management throughout the company, the board should:

- Ensure there is clarity that risk management oversight is the responsibility of the full board, with certain aspects delegated to named committees as appropriate and necessary (e.g., financial reporting risk may be delegated to the audit committee of the board).
- Ensure they understand the company's risk management processes, including management's risk appetite.
- Assess the adequacy of those processes, including how they ensure risks remain within the tolerances set by the board.
- Require at least annually a formal report from the CEO confirming that the risk management processes are adequate.
- Periodically review reports of the organization's aggregate level of risk and each individual risk above a certain threshold.
- Ensure that risks are clearly identified, assessed, and addressed as part of every management proposal (e.g., for acquisitions, changes in strategy, capital acquisitions, etc.).
- Require a formal assessment from the internal auditor, at least annually, of the risk management process and the effectiveness of risk management, including the controls required to manage the organization's more significant risks.

6. ***What are the respective roles and responsibilities of the board, board committees, auditors, key executives, employees and other that may be involved?***

We are in agreement with the description in COSO ERM:

> "Everyone in an entity has some responsibility for enterprise risk management. The chief executive officer is ultimately responsible and should assume ownership. Other managers support the entity's risk management philosophy, promote compliance with its risk appetite, and manage risks within their spheres of responsibility consistent with risk tolerances. A risk officer, financial officer, internal auditor, and others usually have key support responsibilities. Other entity personnel are responsible for executing enterprise risk management in accordance with established directives and protocols. The board of directors provides important oversight to enterprise risk management, and is aware of and concurs with the entity's risk appetite. A number of external parties, such as customers, vendors, business partners, external auditors, regulators, and financial analysts often provide information useful in effecting enterprise risk management, but they are not responsible for the effectiveness of, nor are they a part of, the entity's enterprise risk management."

Additionally, the internal audit activity provides assistance to the board and executive management through its audits and assessment of management's risk management process, and recommendations for improvement. Internal audit – being independent of management and as required *by International Standards for the Professional Practice of Internal Auditing* – can provide independent assurance on the risk framework and risk reporting.

Board Practices

7. ***What is the main lesson from the fact that boards have been unable to direct their companies away from important meltdowns? Is it just a matter of competence or have companies become too large and complex to allow effective board oversight?***

The risk foresight capability of the organization was either not in place or not working effectively. It is also a matter which strongly suggests that the boards may not have been fully competent in their understanding of changing conditions, the key dependencies of their business, or the risks that these presented.

The Board should contain a function which is primarily responsible for corporate governance/risk management that has the power to overrule the board if necessary. There should be standards regarding this including the competence of this function. An appropriate framework and system of risk management and assurance over that framework would help to mitigate business complexity as issue by boards.

However, we also need to recognize that risk management is not risk elimination. There will be events and situations that occur that were not reasonably foreseen (at least to the extent that occurred) and the key will be understanding whether this was due to a failure of the risk management process or the result of the enterprise accepting certain levels of risks in their operations.

8. ***What needs to be done to restore the confidence in the board of directors as a key pillar in corporate governance? Shall legislators and standard setters try to regulate further the composition, qualifications, and size of boards in public companies?***

Ultimately restoration of confidence can be best effected by better competence in risk management and board competence. The following actions are proposed, in addition to the points raised in our response to question 5:

- The OECD should work with other governance authorities to achieve consistent guidance.
- Upgrades to the OECD principles would be valuable; in particular, additional content should be considered around separation of the CEO and chairman of the board; requiring a majority of independent directors; and requiring key committees (audit, governance, and compensation) to consist solely of independent members.
- Strengthening of the tone and content of the OECD principles making it clear that this is less a discussion document and more a set of fundamental principles for effective governance.
- The OECD work with regulators and other authorities (e.g., the governors of the major exchanges) in the U.S. and other countries to develop an international governance framework or related legislation where necessary.
- The OECD benchmark countries with existing regulatory oversight of public companies and Government Agencies (Canada)

Exercise of Shareholder Rights

9. What role did large institutional shareholders play in the financial crisis? In their role as investors and in their role as owners?

Institutional shareholders may have not appreciated their role in driving systematic changes in the system or factored governance issues into the decision making of their investments.

10. Would additional shareholder rights have changed anything in terms of their ability or willingness to monitor CEO's and boards?

The threat of shareholder recourse is potentially a strong incentive for good corporate behavior, and hence shareholder rights may contribute to better governance.

11. In terms of their own business model, incentives and governance structure, what is the most important obstacle to more active and informed ownership by institutional investors?

We have no comment on this question.

The Implementation Gap

While we may need to take a fresh look at some of the existing standards, there is broad agreement that effective implementation will remain a concern. Many countries and companies with formally good standards have still failed.

12. What needs to be done at national and corporate level to close the gap between formal compliance and effective implementation?

Please refer to our answer to question 7 and 8.

13. How can OECD contribute to better monitoring of implementation?

Please refer to our answer to question 7 and 8.

14. How can OECD improve its co-operation with governments, business, and other stakeholders?
Please refer to our answer to question 7 and 8.