RISING TO THE CHALLENGE: CAN INTERNAL AUDITORS PLAY A STRATEGIC ROLE IN TURBULENT TIMES?

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Board members and senior executives are seeking to understand how best they can manage their businesses during turbulent times. More specifically, what kind of shocks that, they may have to face, in terms of business continuity. In this context, can the internal auditors rise to the challenge and be able to play a strategic role to assist the management.

Global Market Instability

The world economy at large is being challenged with the likes of oil price shock, scarcity of food and the resultant economic slowdown. Financial stability exists when the various parts of the financial system such as payments and settlements system, financial markets and financial intermediaries such as banks can operate smoothly and without interruption and with each part resilient to shocks. A stable financial system is able to absorb adverse shocks. The maintenance of a stable financial system is fundamentally important to the operation of the economy. For example, it facilitates the provision of credit, the security of depositors' funds and the smooth operation of payments systems. Serious financial instability can manifest itself in terms of banking crises and recession and can be very costly for any economy in terms of disruption with reduced output and increased unemployment.

It is estimated by the International Monetary Fund that the global economy expanded by 4.9 per cent in 2007 and will grow by 3.7 per cent in 2008. This latter projection is significantly lower than that forecast last October. There are increased signs that the deterioration in the US housing market is starting to spill over to the broader economy and the outlook for consumer spending appears to have weakened. Many observers are of the view that the US economy may experience little or no growth for some time.

Domestic Scenario

Notwithstanding the deterioration in the outlook for financial stability both here and abroad in recent months, domestic financial institutions remain sound and capable of absorbing shocks. Going by the latest financial statistics of the banking sector (first half 2008), Sri Lanka has a healthy domestic banking sector with good shock-absorption capacity. The health of the banking sector remains robust according to the key indicators. The sector continued to prove it is profitable though the level of non-performing loans showed a slightly detoriated state. The comparative thicker margins that the sector continues to enjoy would act as a cushion for any minor variations in market conditions.

However in light of the scale of the disruption in international financial markets, it was inevitable that the domestic banking sector would find it more challenging to continue the same performance and would have to expect difficulties in managing the way forward.

Challenges Ahead

In a high inflationary scenario, reduction in domestic consumption may lead to reduction in demand for goods and services. Suppliers would be compelled to reduce production thereby high level of layoffs and difficulty in meeting their financial commitments. The resultant impact is direct to the banking sector, with low demand for new loans & advances and difficulty in mobilizing deposits. Similarly, retention of existing deposits would be more expensive and maintaining a healthy loan book would be an herculean task that inevitably lead to escalating cost.

> "The real risk of financial statement misstatements lies not in a company's processes or the controls around them, but in the people behind the processes"

Threat of Fraud

Fraud studies have revealed that there are three factors that have to be satisfied namely, the **opportunity**, **motive** and **rationalization** to commit a fraud effectively. This is widely termed as "Fraud Triangle". **Opportunity** generally occurs through weaknesses in internal controls and creates an atmosphere where fraudsters believe they are likely to be successful and undetected. **Motive** often develops from financial pressure resulting from fraudster's excessive life style or gap between his financial commitment and remuneration. **Rationalization** is the fraudster's internal dialog that provides the self justification for his action.

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Turbulent economic conditions provide a conducive hunting ground for the fraudsters. Under turbulent economic conditions, management would be busy in looking for new opportunities, and be compelled to relax policies and procedures to make way for new business, which otherwise would have been rejected. Internal controls are often overlooked and management tends to override controls to make way for such exceptions. If the condition prevails "exceptions become the norm". For instance, a bank may relax the policy to accommodate certain category of individuals who otherwise would have been rejected in terms of the level of disposable income to open a current account and extending facilities. Fraudsters are the first to avail themselves of such relaxed opportunities as a launching pad for their purported fraud.

KPMG International in their latest release of survey results on frauds in 2007 under the caption "Profile of a Fraudster –Survey 2007" revealed interesting facts.

The survey revolves around factual corporate fraud cases investigated over the past few years, that includes cases with material financial frauds. It was a joint exercise by KPMG Europe, India, Middle East & South Africa offices.

- 70 percent of fraudsters were between the ages of 36 and 55 years old.
- 85 percent of perpetrators were male.
- In 68 percent of profiles the perpetrator acted independently.
- In 89 percent of profiles the fraudsters were employees committing fraudulent acts against their own employer, whereas 20 percent involved complicity with an external perpetrator, resulting in the conclusion that in only 11 percent of all profiles the companies were attacked purely by externals.
- Members of senior management (including board members) represent 60 percent of all fraudsters. An additional 26 percent of profiles involve management level persons bringing the total to 86 percent of profiles involving management. This result highlights a risk that every company faces: executives are entrusted with sensitive company information and yet are also often in a position to override internal controls.
- In 36 percent of profiles the perpetrator worked for their company for 2-5 years before committing fraud. In 22 percent of profiles the fraudulent employees registered more than 10 years of service at the victim's organization. In just 13 percent of profiles the fraudster was with the company for less than 2 years prior to committing fraudulent acts.

KPMG International, Fraud Survey 2007

- Greed and opportunity (when taken together account for 73 percent of profiles) are indicated to be the overriding motivations for fraud.
- No prior suspicion existed in more than half of the profiles, but in 21 percent of profiles the companies did not act, even though there was prior suspicion. This raises many questions. Such as, are we, as a society too trusting and unwilling to investigate unless the facts are overwhelming?
- Perpetrators were able to commit fraud by primarily exploiting weak internal controls, in 49 percent of profiles.
- Fraudsters were mainly detected by whistle blowers or management reviews (accumulated 46 percent).

In 89% of the cases, the fraudsters committed against their own employers and in 20% of such cases with the help of external support. In 91% of the instances, the fraudsters did not restrict them to one incident but continued with multiple acts. Most of the white collar crimes were perpetrated by the top management of the corporations.

Rise to the Challenge

It is inevitable that the Board of directors, top management and the business managers have to face and curb fraud apart from running their day to day business under turbulent economic conditions. In this context, internal auditors can be of great help to the management in dealing with the aspect of fraud prevention. However, for internal auditor to be effective in this task, they need a paradigm shift in their yet traditional approach.

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A) Enterprise Risk Management (ERM)

To comply with today's rules, laws, expectations and turbulent conditions, board members and senior executives are seeking to understand enterprise risk management (ERM) in the context of compliance and corporate governance. Some internal audit groups are rising to the challenge by developing strong working relationships with the audit committee and nomination/governance committee, collaborating with other risk monitoring groups in their organizations, advocating ERM programs, and helping to strengthen governance processes.

Internal Audit function can effectively be utilized to connect the dots among sustainable good governance, ERM, and obtaining greater value from compliance activities essentially being the linking pin.

1. Springboard to Improve Governance Process

The Board and its various committees are responsible for overseeing management's risk management processes and a variety of other governance-related activities, with an objective of creating sustainable value for all stakeholders. The Head of Internal audit, as a strategic resource within the organization, should ensure that internal auditing is proactive and interactive with the Board and each committee on the subject of good governance. Such reviews could be used as a springboard to improve governance processes.

2. Experience and Value Addition

Internal auditors can make major contributions to ERM implementation because they have experience with risk assessments, along with a process orientation, objectivity, discipline, and project management skills. Internal audit could effectively add value in an ERM initiative in this organization wide perspective, along with their risk assessment experience.

3. Avoid Resource Duplication

In addition, the scope of internal audit covers the entire organization, assessment of risk, monitoring the assessment process etc. Similarly scope of ERM risk management team would also follow in similar line with responsibility to implement. Without duplicating the process and to save resources, scope of Internal audit could be enriched while maintaining required level of independence.

B) Whistle Blower Practice

With numerous allegations of financial fraud and dubious accounting practices in the headlines these days, organizations are increasingly turning to internal whistle-blower programs to discover and correct improper activities. In fact, Section 301.4 of the much talked about U.S. Sarbanes-Oxley Act of 2002 requires public companies to establish procedures for

a. the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters;

b. the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."

In common, organizations view customer complaints negatively and settle them mostly to neutralize the annoyance. It is worth- while noting that the parties who complain would want to be with the company and hence should welcome them.

Although whistle blowing is commonly thought of as the act of revealing inappropriate activities to parties outside an organization, internal whistle-blower programs allow management to take corrective action within an organization without the negative effects that come with public disclosure.

Apart from external complaints, through these programs, employees are encouraged to discreetly and anonymously disclose concerns about accounting and operational issues. This way, all employees help the organization stay on track.

Internal auditors can play an integral role in the development of whistle-blower programs by working with management to create a system that protects the anonymity of the employees who uses it and gives them maximum access to the tools that will help them report their concerns.

Personally, I myself feel privileged to work in an organization having near perfection system of internal and external whistle-blowing practice and to be a part of that process. Though it requires highest level of corporate sponsorship in terms of resources it requires less. An effective whistle-blower system could include among other things,

- Corporate level sponsorship and organization wide communication
- Policies, procedures in support of the project and adequate awareness
- Process of establishing anonymity where appropriate
- Assignment of reference number for each incident
- Appropriate tracking mechanism
- Easy and user friendly mechanism to report the incident
- Establishment of a unit Independent of the business to manage the process (*)
- Appointment of a committee to investigate and propose action (*)

(*) Service of the Internal auditor could be considered

C) Redress the Approach

Apart from being a vital part of the whistle-blower program and linking pin in the ERM process, leading the assessment process directing from the engine room, internal auditors badly need a change in the way they look at things. It is time that they shift from reactive to proactive approach focusing on external markets as well thinking outside the box as oppose to ticking the box. They are the best consultants that the business can think of to guide them who understand internal capabilities well.

1. Reactive to Proactive

Conventionally Internal audit assignments are post event reviews, often, internal auditors spend their time "patching up processes that worked yesterday but are broken today". Examining the root cause would probably help internal audit to add value to business process with greater acceptance. Similarly, reviewing processes proactively in terms of "what could go wrong" approach would be more meaningful as opposed to reactive approach in turbulent market conditions. For Instance, Internal auditors could be part of the core team that implement a strategic IT application who provide assistance with regard to control aspects of the system as opposed to writing lengthy reports post implementation, highlighting weaknesses.

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2. Conformance to Performance

Traditional Internal audit approach has been to carry out a strict compliance review which highlight the deviations. Most auditors never bothered to inquire why the rules were bent. The rigidity in processes in a dynamic market was often overlooked by auditors. Internal auditors could be of more use to business if they changed the focus from conformance to performance especially in a turbulent market scenario. It would, no doubt, would turn a typical assignment into something more meaningful to executives.

3. Box Tickers to Think Outside the Box

To achieve corporate objectives, companies have to carry out both conformance and performance related work. The secret is to understand that the two are not mutually exclusive. As opposed to strictly commenting on non-conformances, Internal audit can review the process efficiencies, performance evaluations, economies of scale, business process re-engineering etc focusing outside the box.

4. Fault Finders to In-house Consultants

Since of late for Corporate boards, it is more a fashion now to field external consultants with a "big name" to tell them how the business should be run in effective manner. The buzz words such as "BPR, Business Process Re-engineering" , "Six Sigma" ,"360 Degree feedback" "ERM" etc has now become a common terminology at the Board Rooms. It is worth questioning the level of understanding of business values and internal cultures by such external consultants to provide an effective input.

It is felt that the Internal audit could best perform this task as the most qualified in-house consultant in terms of wealth of experience in dealing with the issues internally who understand best the internal values and strengths and weaknesses of business resources.

5. Internal Focus to Internal & External Focus

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Internal auditors used to focus internally on the processes, procedures , practices within an organization mostly without much reference to external developments. Now, the internal auditor needs to be both focusing on inside and outside the company. Internal auditors need to know their own company very well, and they also need to know what other firms in their industries and in other industries are doing. Their inside knowledge tells them where to focus attention, and their outside knowledge helps them make constructive and authoritative suggestions and comparisons. A key role of the internal auditor is to employ benchmarking not for comfort and complacency, but to highlight opportunity and challenge.

6. Process Focus to Human Focus

The real risk of financial statement mis-statements lies not in a company's processes or the controls around them, but in the people behind the processes and controls that make the organization's control environment such a dynamic, challenging piece of the corporate consciousness.

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6.1 Errors and Frauds

Reports and papers that analyze misstatement risk use words like "mistakes" and "improprieties." Automated controls don't do anything "improper" of if it is not designed to do so. Similarly record keeping systems and data management processes don't make "mistakes". Computers and systems don't carry-out frauds but people make mistakes, and people commit frauds.

You can have a well-designed control, but if the person in charge doesn't know or care what to do, that control won't operate. A negative behavior of an employee in terms of control doesn't mean that employee is a bad worker. It may simply mean he or she is new to the job, or it may reveal training problems in that employee's department. Internal auditors need to keep in mind that, in some instances, competence may be so low that it results in greater risk.

Human error has always been part of the internal auditor's universe, risk based assessment of a company's control environment with a view to target controlled processes need to focus on the ability and integrity of the people who handle the function.

Focusing on the human element of mis-statement risk is one important way companies can make a significant difference in finding their true financial statement exposures. It also represents an opportunity for management to identify the weak links that could ultimately result in a mis-statement, as well as for internal audit departments to make management's evaluation a much simpler task.

Dramatic corporate meltdowns like Enron and WorldCom could happen under today's regulatory strictures because the controls weren't the problem, the people were. That hasn't changed. Hence, smart internal auditors are integrating the performance evaluation information, soft skill assessments etc which are extremely important for such an approach.

6.2 Mistaken Judgment

The more complex a control, the more likely it is to require complicated input data and to involve highly technical calculations that make it difficult to determine from system output whether something is wrong with the process itself. Having more human judgment involved gives rise to greater apparent risk.

> *"Having more human judgment involved gives rise to greater apparent risk"*

A computer will do exactly what we tell it to over and over. A human may not, but that's what makes people special and risky. In the case of controls, our human uniqueness can manifest as simple afternoon sleepiness or family troubles that prove too distracting to put aside during the workday. So many things can result in a mistaken judgment and simple mistakes in judgment can be extremely material to the financial statement.

Conclusion

It is quite evident that the Board members and the top management is now seriously faced with the challenge of steering their corporate through a turbulent economy. It is inevitable that such economies are subjected and continue to influence by the external shocks. Internal auditors have to rise to the challenge and can be of great help to the Board of Directors and management. Board Room doors are now increasingly being opened for the internal auditors and they are frequently being consulted.

No matter how much speed a design of a car accommodate, one cannot achieve the required speed, if the model comes without an effective system of breaks. Similarly, in managing corporates especially in turbulent times, if the business intends gaining momentum, it has to have the right mix of controls to steer well. Could it be, policies, procedures, office of compliance, risk management or governance, the internal auditor has a vital role to play.

Apart from other challenges, the top management is faced with the risk of frauds where internal auditors can help management well manage the situation. Internal auditors while acting as a linking pin in an ERM program can help launch an effecting whistle-blowing system. Internal auditors now need to act as in house consultants who think outside the box, with a proactive and performance oriented human focused approach with a close eye on the external market.

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