Learning from events and black swans

The words *I told you so* hold no pleasure for internal auditors. They are a sign that it is too late to save a reputation, a project…an organisation. Audit leaders strive to be ahead of the curve, to provide assurance that matters, is relevant and is heard.

Internal audit positions itself as the board's trusted advisor. Official post-event investigations take many years while the real-world needs answers and assurances today. Audit leaders must be unwavering at all times, not just when the spotlight is on, in providing assurance that addresses the root cause of issues not just the symptoms that manifest. This means thinking outside of the box, challenging assumptions and questioning what will be next.

Following a litany of corporate scandals, extreme weather events and tragic accidents, audit leaders may wonder if their audit plan is right or if their organisation has identified all its critical risks. Then again, some things may only become visible with the lens of hindsight. Such unforeseen events are known as 'black swans.'

Was the 2020 coronavirus pandemic a black swan or was it a crisis management event that organisations, including governments, should have been prepared for? Regardless of how we might classify it, the initial impact will undoubtedly be higher than any risk register estimates with global economic recession, massive sovereign debt, high unemployment, and organisational failures across multiple sectors.

In this thought leadership article we look at the priorities of internal audit against the backdrop of the black swan concept and offer insights into two high profile events through that lens – the 9/11 terrorist attacks and the 2008 financial crisis.

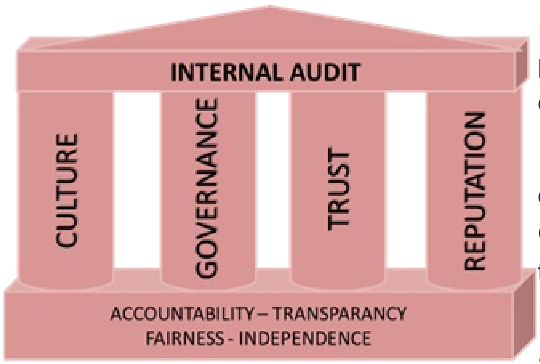
Clear priorities

Internal audit is clear on its purpose. To provide independent assurance that an organisation's risk management, governance and internal control processes are operating effectively.

Achieving this in a world of almost exponential complexity and uncertainty is not easy.

Internal auditors at all stages of their career will have looked again at procurement and contract management practices in the wake of the Carillion debacle. Likewise, business resilience tends to be higher profile after natural disasters and financial compliance checks were undoubtedly reprioritised by internal auditors following fraud at Patisserie Valerie.

Such audits provide useful assurance, but internal audit should also be insightful and adding value at a strategic, root cause level.



In recent years internal audit has prioritised four content pillars; the reason is clear when we look at some headline events.

In July 2017 an appliance caught fire in a flat. The fire engulfed the tower block with the loss of 72 lives. Was the Grenfell Tower tragedy preventable or a black swan? After two years the official investigation remains ongoing.

In February 2017, five months before the Grenfell tragedy, Southwark council was issued a fine of £270,000 for a fire at Lakanal House in 2009 in which six people died. The coroner recommended that sprinklers should be retrofitted to all tower blocks that the "stay put" policy should be reviewed, and cladding should be fireproof. The recommendations were not compulsory.

This was not an isolated case. Investigations into high-rise fires in Merseyside in 1991 and Irvine in 1999 identified cladding as an accelerant. There have also been similar incidents overseas in France, Australia and the UAE.

The Hackitt Review (Independent Review of Building Regulations and Fire Safety) following the Grenfell fire found that 'the whole system of regulation, covering what is written down and the way in which it is enacted in practice, is not fit for purpose.' The government responded by establishing a fund to enable inadequate cladding to be identified and removed from buildings; as of July 2019, 107 of the identified 431 buildings had been completed.

This prompts questions for all audit leaders:

- When agreeing actions with management, how much pressure should internal audit apply when due dates are too far out leaving the organisation exposed to significant risk?
- How brave does a chief audit executive need to be when management and the internal highest governance bodies tolerate risks that are unacceptable in the public interest?
- What assurance does internal audit provide over the setting and application of risk appetite?

When construction and facilitates management firm Carillion collapsed, it sent shockwaves throughout the industry. At the time of insolvency, they held c420 public sector contracts, 45% of their UK revenue; it left services in jeopardy and projects in limbo. A parliamentary inquiry found the directors guilty of ‘recklessness, hubris and greed’ citing them as lacking ‘even a tenuous grip on reality.’

This also raises questions:

- What role should internal audit have in assessing board effectiveness?
- Have you audited board recruitment including the skill mix?
- Does the audit committee/board respect and demand audit reports that are both challenging and constructive?
- How robust is your assurance around third parties and the wider supply chain? It is was of the key topics in Risk in Focus 2020?

A 2019 report found that brand trust was a purchase decision factor for 81% of people yet only a third of people said they trusted the brands they buy. The car industry in particular has been heavily impacted in the wake of the diesel emissions scandal that began with Volkswagen and extended to many other manufacturers.

And yet more questions:

- What assurance does internal audit provide over the metrics, information and processes that influence stakeholder trust levels?
- Do audit leaders understand the importance of reputation as an auditable asset?
- How do auditors recognise and assess ‘taken for granted assumptions’ such as internal algorithms or external standards?

When rationalised after the event, it sometimes seems hard to believe that any organisation with a reasonable level of governance, risk management and internal control could allow things to escalate to such an extent. Yet it happens. And lessons are not learnt.

Barriers to learning

It has long been said that we have to make mistakes to learn from them.

According to Christopher G. Myers, Academic Director of Executive Education at the Johns Hopkins Carey Business School, when as individuals we are unclear how to take personal responsibility for a problem we are “less likely to internally attribute a failure, and thus less likely to learn.”

He further suggests that even when people are open to learning from their mistakes, any “ambiguity of responsibility” can undermine this resulting in lessons being missed or attributed to bad luck or factors outside their sphere of influence.

Using this concept, it is easy to see how events which executives read about, the collapse of Thomas Cook, fraud at Patisserie Valerie, undisciplined tweets by Elon Musk do not compel them to drive change in their own organisation. They can be readily dismissed as distant happenings in other organisations, sectors or geographies.

Conversely internal auditors often seek external practices and ideas to add value. Should audit leaders encourage their business colleagues to do more of this?

An additional barrier to learning is bias. Of the 12 common types, we will look at two.

Unconscious bias

Unconscious bias happens without our awareness. It influences our judgements and decision making based on our experiences, backgrounds, values and environments.

Consider for a moment when Oxfam hit the headlines in 2018 following a sexual misconduct scandal involving senior aid workers in Haiti. At the time there was also significant media attention of the #MeToo campaign and gender equality, individuals and organisations were concerned about their actions.

- What role did unconscious bias play in board meetings up and down the country?
- Were factors such as the age of the men involved, and their social class looked at?
- Did the fact that the Oxfam incident happened overseas and concerned a charity the perceived importance of the issue?
- How often did the conversation move on to the bigger picture of culture and reputation?
- As audit leaders do you know how your organisation responded – review charitable activities, overseas activities or did it not make the radar?

Confirmation bias

Confirmation bias is our tendency to look for information that confirms our existing beliefs or ideas. It is why two people with opposing views on a topic can see the same evidence and come away feeling validated by it. This is why SAGE (the Scientific Advisory Group for Emergencies) advised the government during the coronavirus pandemic rather than rely on a single source of expertise.

This is powerful enough on its own but even more so when compounded by lack of analytical reasoning due to competence or time. Auditing encourages constructive scepticism, using the ‘5 Whys’ to get to root causes. Board members with confirmation bias will happily take the first data that suits their perspective.

It is also dangerous when combined with group think. Boards can be blind to the warning signs from internal audit, the newbie, the harbinger of doom from legal…they think the project they are signing off will be successful, their organisation is too big to fail and that they instinctively know what is right.

Investment magnate Warren Buffett said, “*what the human being is best at doing is interpreting all new information so that their prior conclusions remain intact*.” During the coronavirus pandemic as airlines around the globe strived to get ‘back to normal’, Buffett sold all his firm’s entire holding in four major airlines, recognising this was unlikely as the “world has changed” potentially for ever, for the industry. Audit leader can learn from Buffett, an important part of internal audit’s role is to identify where this is happening and break down the barriers to learning.

How many headlines might never have been printed if issues in governance and culture had been addressed rather than swept under the carpet?

Avoidance

Addressing the real issues, the ones that keep audit leaders awake at night is rarely easy.

Writing in the Harvard Business Review, Ron Carucci used insights from a 10-year study to identify three reasons why top executives avoid tough decisions.

1. **Not wanting to disappoint people.** This can manifest in lots of ways from putting off redundancies, stalling a choice between investment projects, explaining underperformance to stakeholders or simply

disrupting the status quo.

2. **Fear of looking stupid.** For some this may be the reason behind a desire for excessive analysis and procrastination, trying to find certainty or seeking other options to avoid making a mistake or taking a risk.
3. **Perceived as being uncaring.** An inability to effectively performance manage, giving people too many chances to prove themselves, striving for equity rather than promoting excellence and failing to exit poor performers.

Internal auditors cannot force decisions to be made but they can be mindful of the psychology of decision-making so as to work through it rather than face a wall of indecision.

The choices that boards and executives make shape the organisation's decision-making culture. Where self-protection and self-interest are motivations for avoiding difficult choices, this filters down through the management structure. Audit leaders can use the stewardship concept, good governance and board effectiveness insights at every opportunity to encourage a positive cultural rethink.

Are there times though when even robust governance, risk management and internal controls are taken by surprise?

Black Swans

A black swan is a metaphor for an event that is unexpected, has major consequences, and after the event is often rationalised with the benefit of reflection time.

The concept was popularised by Nicolas Taleb as risk management gained in profile. His book, The Black Swan, he identified three attributes for the events:

- It is an outlier, beyond the realm of expectations, experience cannot point to its possibility
- It carries an extreme impact
- After the fact we produce explanations for its occurrence making it explainable and predictable.

The "*unknown unknowns"* that Donald Rumsfeld famously referred to.

Internal auditors may question the concept:

- Does it suit risk professionals and board members to have plausible deniability?
- With the right tools and mindset surely nothing is beyond comprehension?
- Do black swans simply serve the psychological barriers to decision making?

Consider two high profile examples of black swans; the events of 11th September 2001 and the financial crisis of 2008.

September 11

2,977 people lost their lives when four commercial aircraft were hijacked, one was flown into the Pentagon, two into the twin towers of the World Trade Centre which subsequently collapsed and the fourth was forced to abort its target by passengers and crew crashing instead into a field.

Over 2000 people have subsequently died from related illnesses plus 75,0000 are being monitored or receiving healthcare as part of a Trust fund. Property damage cost about $100 billion and estimates of the total economic damage inflicted by the attack range up to $2 trillion.

Some experts now suggest that the integrity of the building structure was compromised due to the heat from the burning aircraft. The aluminium creating a hotter fire than the other components, a factor not included in simulations or scenarios when planning resilience nor during the initial investigations after the event.

Whilst it was and remains the most devastating terrorist attack in recorded history, was it a black swan? For instance, some facts do not require hindsight:

- Robust business resilience planning considers a wide range of scenarios
- The towers were located close to major airports
- Terrorists had previously targeted the site

Is it possible that the collapse of the towers, the worst possible outcome, was so unthinkable that it was avoided by the human psyche, like the unsinkable Titanic almost a century earlier that was designed without sufficient lifeboats?

Internal auditors pride themselves on their independence and objectivity. How do you protect your critical thinking process from unconscious bias? Do you limit your thinking to what is acceptable?

Global financial crisis

Lehman Brothers and Bear Stearns led the domino effect of firms that were too big to fail when the consequences of the credit and housing bubble crisis in the United States caused a financial tsunami across the globe.

OCED research found that actual GDP for the 19 countries that make up its membership is 10% lower in the decade post-crisis than forecasts pre-crisis. Whilst this is subjective because of a raft of variables, the actual costs have been felt in low interest rates, unemployment, inflation, austerity measures and house prices. The Institute for Fiscal Studies says real pay may not pass the pre-crisis peak until 2022.

Speaking at the International Monetary Fund in 2006, economist Nouriel Roubini warned about the potential economic crisis. He was derided as Mr Doom. He was not alone, other economists and advisers also talked about the impending recession but were ignored. As early as August 2007 the French investment banking giant BNP Paribas prevented investors from accessing money in funds with subprime mortgage exposure.

Risk consultant, Richard Anderson, uses the phrase "*perfect place arrogance*" about the culture inside financial institutions in the lead up to the crisis. In the years that followed he called on risk professionals to be the disruptive intelligence to pierce it.

- As an audit leader, are you a disruptive intelligence in your organisation?
- Have you provided assurance over the organisations finance strategy…debt management for instance?
- What could be the 'arrogance' that brings your organisation or sector to its knees?

Again, we ask was this truly a black swan event. The widespread criticism of bank risk appetite has led to major reform and governance improvements. It also put corporate culture into the spotlight, one of the pillars the Institute encourages audit leaders to address.

Closing Thoughts

The lesson for internal auditors is not about being alert to particular process or control weakness: that is the day job. It is to look beyond the operational detail and the obvious answers. It is to think strategically, to ask the five whys, to be objective and analytical; and in the wake of a crisis asking what will be the next one, what do we assume cannot fail, how can we improve. The learnings for audit leaders are about courage, advocating an open culture where mistakes are equal in value to success and enabling voices to be heard.

What will you do with your learnings?

"We learn much more from failure than we do from success."

Alan 'A.G' Lafley, former CEO Procter & Gamble