

## Where was internal audit? Corporate failures and the role of IA



"Where were you?" is the question asked of external audit when corporate failures hit the headlines – Enron, Toshiba, Patisserie Valerie, Thomas Cook, Carillion... is the same question aimed at internal audit when a project goes off the rails or a control fails?

Psychic abilities are not listed on IIA Global's core competency framework. So to answer this question, we take a candid look at the role of internal audit and ask whether it is a reasonable expectation that internal audit has 20/20 foresight at all times.

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### The story behind the question

As the third line of defence, internal audit has an important role in the corporate governance framework: to enhance and protect organisational value by providing risk-based and objective assurance, advice and insight.

Taking the lines of defence analogy literally would suggest internal audit is the backstop within the organisation; the goalkeeper making a glorious save when the opposition break through the defence.

Organisational defences are more complex than a back four on the football pitch, making it virtually impossible for a team of internal auditors to be the corporate goalkeeper unless they individually mark every board member 24/7.

In reality the independence of the third line puts internal audit closer to the role of referee in a tight derby game: expert in diplomacy and the rule book, respected for fairness, issuing warnings and overseeing the action. Like the referee, audit leaders are constantly maintaining pace with the game and looking ahead to the next move.

Speaking in October 2019, Sir Donald Brydon, leading the review into UK audit voiced his frustration that the world of audit was being blamed for everything, he said “it is not auditors that cause companies to fail, that’s the result of the actions of directors”.

It is true of both external and internal audit. However, as internal auditors it is our responsibility to call out the poor governance frameworks, ineffective internal control environments or immature risk management that leads to such failures. Without negating the accountabilities of the directors, internal audit can provide the yellow card warnings as the conscience of the board.

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## Where were you? A case study

A chief audit executive (CAE) shared their experience of being asked this very question with the Chartered Institute; details of the company have been changed to maintain confidentiality.

Company X is a respected organisation both publicly and within the industry. When a whistle-blower raised the alarm on a serious long-term fraud it led to employees being dismissed, financial loss and negative media attention.

The investigation asked questions of internal audit, but, more importantly internal audit asked questions of itself. The CAE’s goal focused on constructive learning, not blame.

After ploughing through over a decade of audit files the team identified that the area in question had been audited a few years prior to the discovery. The control weakness had been identified that the fraudster exploited, and management had accepted the risk on the basis that a system fix for the control was imminent. Subsequent to the audit, priorities changed, and the fix was deferred.

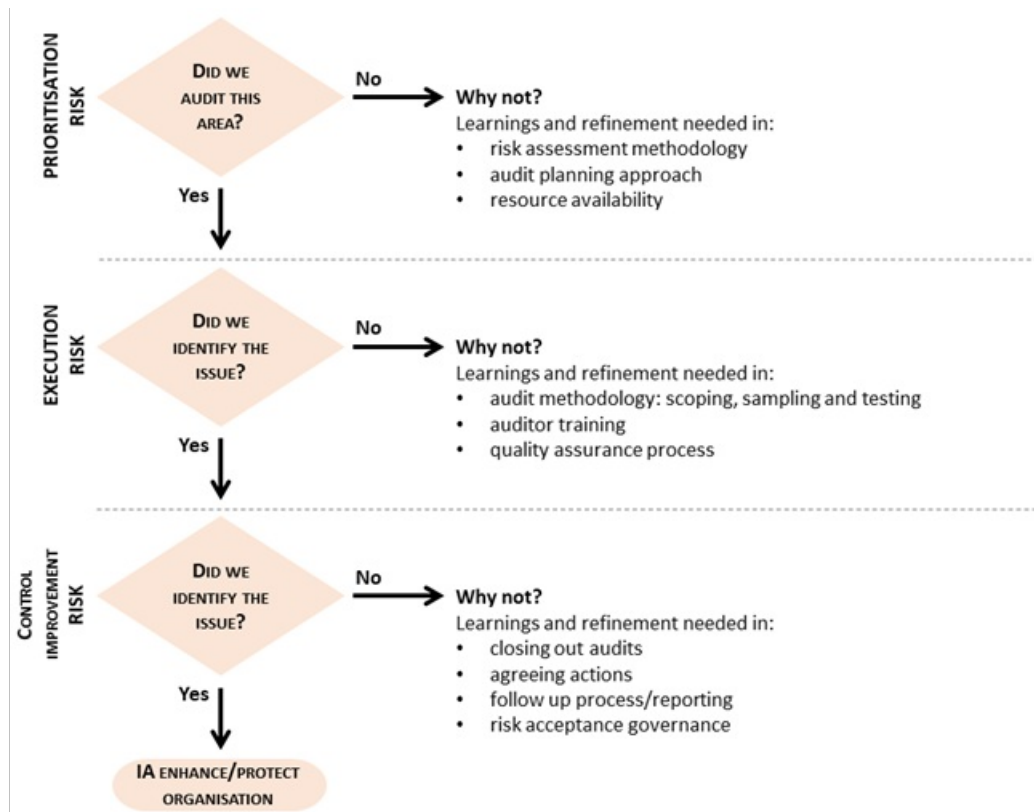
The CAE refined the oversight for risk acceptance introducing improved governance with defined review points and reporting.

The audit learning process focused on three key risks:

1. Inappropriate prioritisation of audit resource leads to material risks not being assured
2. Poorly executed audit engagements lead to false assurance
3. Insufficient action to address known control weakness results in failure

Take a moment to think back over the last 18 months in your organisation.

- **What risks have materialised?**
- **Could you use this learning process?**



## Managing the risk

Being asked the question 'where were you' is a risk that audit leaders must be able to mitigate.

Or, at the very least, respond to positively.

In simplistic terms it is impossible for internal audit to provide absolute assurance over everything – even the highest performing functions with an unlimited budget would struggle to achieve it. There will always be the likelihood of something going wrong so what are you doing in preparation?

Key controls to consider include:

- **Bravery as a core competence for internal auditors:** While not part of the formal IIA Global framework, this is an essential personal attribute at all levels to ensure that 'difficult to report' test results are followed through to conclusion or that audits management tries to avoid are progressed, ie prompt and accurate follow up is in place.
- **Stakeholder management – setting expectations:** Reinforcement that assurance enables board oversight, internal audit is not accountable for decision making and running the organisation – that is the role of management as is their responsibility to identify and mitigate risk and implement an efficient and effective control environment.
- **Access to required skills:** Auditor skills should enable not define the audit plan, audit leaders must ensure adequate training and use of supplementary resource (guest audit programmes, co-sourcing, out-sourcing) as necessary to deliver the required assurance.

- **Robust risk assessment processes:** Internal audit should be risk-based using comprehensive processes to identify the risks where board and management assurance is required, ie remain relevant to the organisation or risk becoming obsolete.
- **Dynamic audit planning:** Most organisations experience volatility and complexity together with uncertainty, the audit plan should be flexible enough to maintain pace with changes in the risk profile. Does the operational annual plan have to be 12 months? Would 6 months or even a quarterly plan work better for your organisation.
- **Transparent assurance gap:** Audit leaders must be explicit about the risks that are not being audited, highlight the top ones and the rationale for example perhaps using a heat map or create an assurance map that provides transparency and clarity around who is the provider of assurance against which risks.
- **Active risk acceptance process:** Management isn't always in a position to invest in controls or might not agree with internal audits opinion, when risks are accepted the decision should be reviewed not closed.

There have been some high-profile cases that audit leaders can learn from.

The parliamentary **report** following the collapse of Carillion concluded that “Deloitte [fully outsourced function] were responsible for advising [the] board on risk management and financial controls, failings in the business that proved terminal. Deloitte were either unable to identify effectively to the board the risks associated with their business practices, unwilling to do so, or too readily ignored them.”

- **Is your function structured and resourced appropriately?**
- **How brave are you as an internal audit professional?**

It was a similar finding after accounting irregularities at **Toshiba** led to a high profile scandal in 2015. The subsequent investigation noted that internal audit was not providing adequate assurance and even suggested that internal audit had been aware of several projects with inappropriate accounting but took no action.

- **How robust is your audit planning approach?**
- **Do your actual audit findings reconcile with what is reported?**
- **Is there a transparent process for determining materiality?**

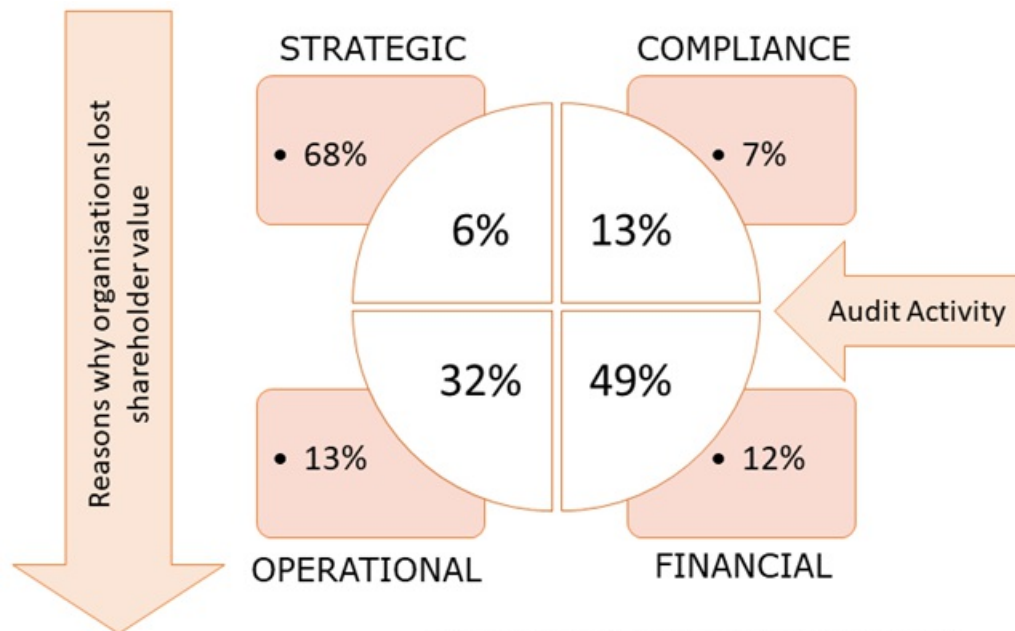
After the high profile incentive scheme scandal at **Wells-Fargo** in 2016 the organisation revised its governance structure and increased its internal audit resource to enable dedicated teams to be focused on board governance, inconsistent customer practices and capital management; a reaction to failed controls across all three lines of defence.

- **Are your lines of defence joined up?**
- **What key controls could fall between the silos?**
- **How well integrated is your organisational assurance?**

## Where will you be?

Research by the Corporate Executive Board in 2010 found that organisations mainly failed due to strategy yet this was an area of limited internal audit assurance.

- How different would the graphic be using current data?
- Have things changed?
- Where do you focus your audit activity?



Source: *The Future of Internal Audit, Corporate Executive Board 2010*

To protect the organisation, internal audit must operate at the very highest level – providing assurance on governance, risk management and internal controls at board level not within the minutia of financial and operational processes.

Audits that are typically considered challenging for auditors are the very ones that are most likely to identify potentially catastrophic weaknesses in time to address them; organisational culture and ethics, strategic decision making, non-executive recruitment, board effectiveness and executive performance reporting.

Carillion was cited as having a “rotten corporate culture” by two government committees.

- **Have you provided assurance to the board on these critical areas within your organisation?**

As audit leaders does your assurance rely on historic assurance or does it look to the future giving insight in relation to risk, control and governance. Looking ahead to 2025 and beyond, is your organisation’s business model fit for purpose?

## Closing Thoughts

The way in which your audit stakeholders perceive you is out of your control. But you can inform their opinion, shape their expectations and build strong relationships based on integrity and trust. It is how you operate as audit leaders and as an audit activity, day to day, that is key to how you will be able to answer the question if it is asked of you.

*"Do what is right, not what is easy."*

**Anonymous**