INTERNAL AUDIT AND THE RISING CORPORATE SCANDALS

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Presenter: CPA Ronald Wanyama

Outline

- Introduction
- What are Corporate Scandals?
- Causes of Corporate Scandals
- The Role of Internal Audit
- Examples of Corporate Scandals
- Measures to deal with Corporate Scandals

Introduction

- A corporation is a legal entity that enables individuals to contribute and pool resources, capital, and labour in order to generate a profit.
- Corporations establish governance structures that specify the distribution of rights and responsibilities among the different parties.
- A proper governance structure will also lay down the rules and procedures for decision making within the Corporation.
- In some cases shareholders, have not even benefitted that much from the laser-like focus on profit above all else due to corporate scandals perpetrated by corporate executives.

Corporate Scandals

- Corporate scandals refer to a set of questionable, unethical, and/or illegal actions that a person or persons within a corporation engage in.
- Typically, they are questions about the corporation's actions, which are either allegedly illegal or actually proven to be illegal
- The main objective of persons who indulge in various types of undesirable practices is to enrich themselves
- The actions often become wide public incidents
- Corporate scandals are not unique to any particular country or continent

Causes of Corporate Scandals

- In order for fraud to occur, three conditions must exist:

a) rationalization by the person committing the fraud,

b) incentives or pressures to commit fraud,

c) the opportunity to do so.

These factors are commonly known as the Fraud Triangle.

Causes of Corporate Scandals

1) Greed

The urge to earn money and become rich overnight is the biggest cause of scandals. Many people lack the patience and the will to work hard. They prefer a short cut to have wealth and status in society. They adopt illegal and antisocial practices to fulfil their desire.

2) Lack of morality

The declining levels of morality and ethics in society is another major cause of corporate scandals. Common people emulate their role model (eg politicians, film stars, sports stars). When these role models indulge in unethical practices, people also do not mind corrupt behaviour.

Causes of Corporate Scandals

3) Corporate Governance Failures

- ✓Irresponsibility of the boards and senior management.
- ✓Control either by the chairman or CEO over the BOD
- ✓Ineffective Internal and external audit

4. Failure by the Regulatory Authorities

- ✓To enforce standards/guidelines and coordinate with one another

Causes of Corporate Scandals

5. Loopholes in law

- ✓Corporate scandals proliferate in a society where legal machinery is over burdened and the victims get justice after enormous delay.
- ✓When offenders are not prosecuted for illegal and antisocial actions, they are not afraid to face the consequences and others get encouragement to break the law.

Types of Corporate Scandals

1) Falsification of Accounts

- Involves manipulation of accounts and financial statements. As a result, they do not present a true and fair picture of the company’s financial position.
- Shareholders, bankers and other stakeholders are misled.
- Some of the methods usually adopted to falsify accounts are

a) Showing fake and excessive expenses in the books of account.

b) Making bogus entries in the books of account with some ultimate motive.

Types of Corporate Scandals

c) Undervaluation or over valuation of stock.

d) Charging excessively low or high depreciation in order to inflate or reduce profits.

e) Over valuation or under valuation of assets

f) Over valuation or under valuation of liabilities.

g) Making fictitious entries of loans

Types of Corporate Scandals

2) Under invoicing

- Importers are required to pay custom duty on imported goods generally according to the value of imports.
- Importers ask the exporters to show low prices of goods in the invoice so as to minimize custom duty payment.
- The difference between actual prices and prices shown in invoice is remitted to exporters through illegal means. In such cases, customs officials are also bribed to get clearance of imported goods.

Types of Corporate Scandals

3) Over invoicing

- Exporters get cash and other incentives from the Government as a means of export promotion.
- Some exporters overcharge in the invoice to claim greater amounts of incentives.
- They compensate foreign buyers for the difference in prices by illegal means.
- Thus, under invoicing and over invoicing are scandals adopted by companies engaged in international trade.

Types of Corporate Scandals

4) Tax evasion

- Many business firms suppress their sales turnover and net profits so as to reduce their tax liability.
- Bribes are paid to tax officials for assessing lower turnover and projects.
- Tax evasion is more common in case of income tax, excise duty and stamp duty.

Types of Corporate Scandals

5) Improper disclosures

- ❑Liability omissions
- ❑Failure to disclose subsequent events
- ❑Withholding information about management fraud

The Role of Internal Audit

- Putting the right controls and making sure they work has always been in the heart of corporate governance.
- Companies usually therefore have multi-layer systems of controls.
- The first layer lies usually within each department where work procedures ensure the presence of controls aiming to minimize the space for errors and misconduct.
- The CEO gets the assurance that internal controls are sufficient and are working well through the internal audit function.

The Role of Internal Audit

- Corporate scandals encompass a wide range of irregularities and illegal acts characterized by intentional deception or misrepresentation
- The rising corporate scandals demonstrate the need for organizations and governments to improve governance and oversight.
- How to address fraud risk within an organization effectively and efficiently is a major topic of concern for boards of directors, management, business owners, internal auditors, government leaders, legislators, regulators, and many other stakeholders.

The Role of Internal Audit

- So how can internal auditing best serve as a resource and play an integral role in Corporate Scandals prevention and detection?
- The Institute of Internal Auditors *International Standards for the Professional Practice of Internal Auditing (Standards)* pertaining to fraud and the internal auditor’s role in detecting, preventing, and monitoring fraud risks and addressing those risks in audits and investigations include:

The Role of Internal Audit

- **IIA Standard 1200: Proficiency and Due Professional Care**

1210.A2 – "Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud".

- **IIA Standard 1220: Due Professional Care**

1220.A1–"Internal auditors must exercise due professional care by considering the:

… Probability of significant errors, fraud, or noncompliance.

The Role of Internal Audit

- **IIA Standard 2060: Reporting to Senior Management and the Board**

"The Chief Audit Executive (CAE) must report periodically to senior management and the board on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan. Reporting must also include significant risk exposures and control issues, including fraud risks, governance issues, and other matters needed or requested by senior management and the board."

The Role of Internal Audit

❑ IIA Standard 2110: Governance

The internal audit activity must assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives:

- ✓ Promoting appropriate ethics and values within the organization;
- ✓ Ensuring effective organizational performance management and accountability;
- ✓ Communicating risk and control information to appropriate areas of the organization; and
- ✓ Coordinating the activities of and communicating information among the board, external and internal auditors, and management.

The Role of Internal Audit

- 2110.A1 – The internal audit activity must evaluate the design, implementation, and effectiveness of the organization’s ethics-related objectives, programs, and activities.
- 2110.A2 – The internal audit activity must assess whether the information technology governance of the organization supports the organization’s strategies and objectives.

The Role of Internal Audit

- **IIA Standard 2120: Risk Management**

2120.A2 – “The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk.”

- **IIA Standard 2210: Engagement Objectives**

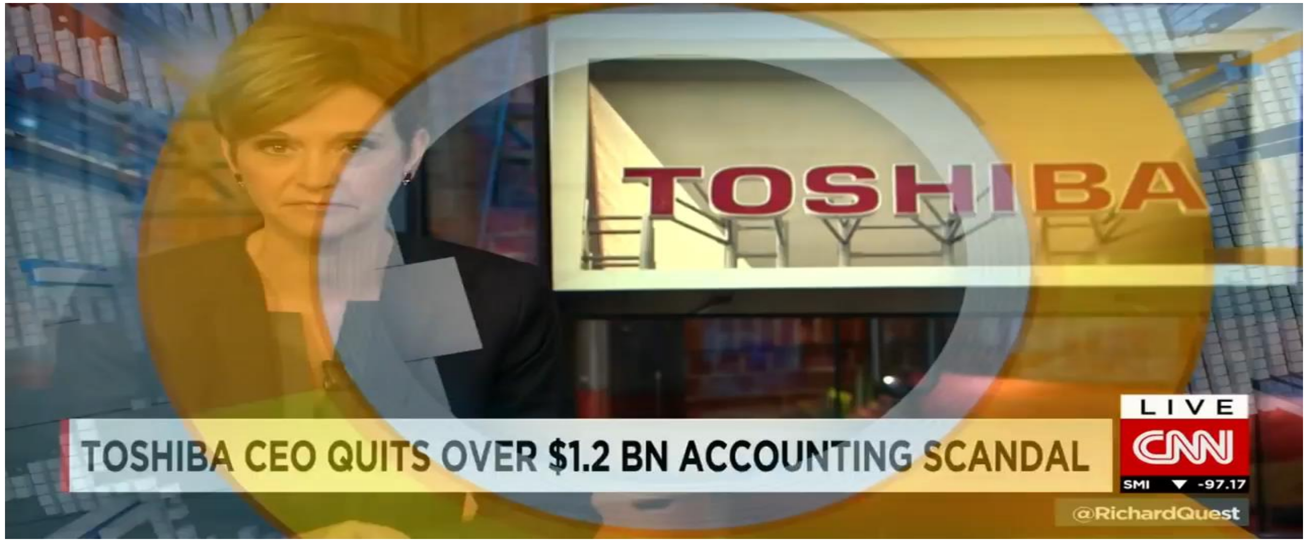
2210.A2 – “Internal auditors must consider the probability of significant errors, fraud, noncompliance, and other exposures when developing the engagement objectives.”

Examples of Corporate Scandals

1) Toshiba

- The venerable conglomerate makes everything from consumer electronics to nuclear energy technology
- Toshiba had been viewed as a pioneer in Japan in adopting an "audit committee" structure more commonly found in Western corporate governance.
- Was accussed of systemic and prolonged financial misstatements
- An Independent Investigation Committee report concluded that Toshiba overstated profits by 151.8 billion yen (US$1.2 billion) from 2008 to 2014.

Examples of Corporate Scandals



Examples of Corporate Scandals - Toshiba

- Toshiba's internal audit function adopted a rotational staffing model, and internal auditors were recruited with the explicit understanding that they would rotate through the department in route to other opportunities within the company.
- There are pitfalls when the model is not well thought out based on the organization's specific needs.
- An excessive reliance on the rotational staffing model left the internal audit department vulnerable in terms of resources and competency in accounting and in the company's ability to conduct effective audits.

Examples of Corporate Scandals - Toshiba

- Toshiba's governance structure relied too heavily on internal audit as a consulting service rather than as an assurance provider.
- The audit department focused primarily on providing consulting services, without assessing the appropriateness of accounting processes.
- While an effective internal audit function often provides advice and consultancy services for key stakeholders, internal audit will often struggle to address a company's critical risks if little or no assurance is provided on the overall effectiveness of mitigating controls.

Examples of Corporate Scandals - Toshiba

- Despite a limited focus on assurance, audits by the department twice identified instances of irregularities that could have highlighted the company's accounting problems much earlier.
- However, they were dismissed as not significant enough to report.
- Had Toshiba auditors taken the additional steps to try to understand the accounting anomalies, they likely would have uncovered the bigger problem much sooner.
- But they may not have had the skill to connect the dots.

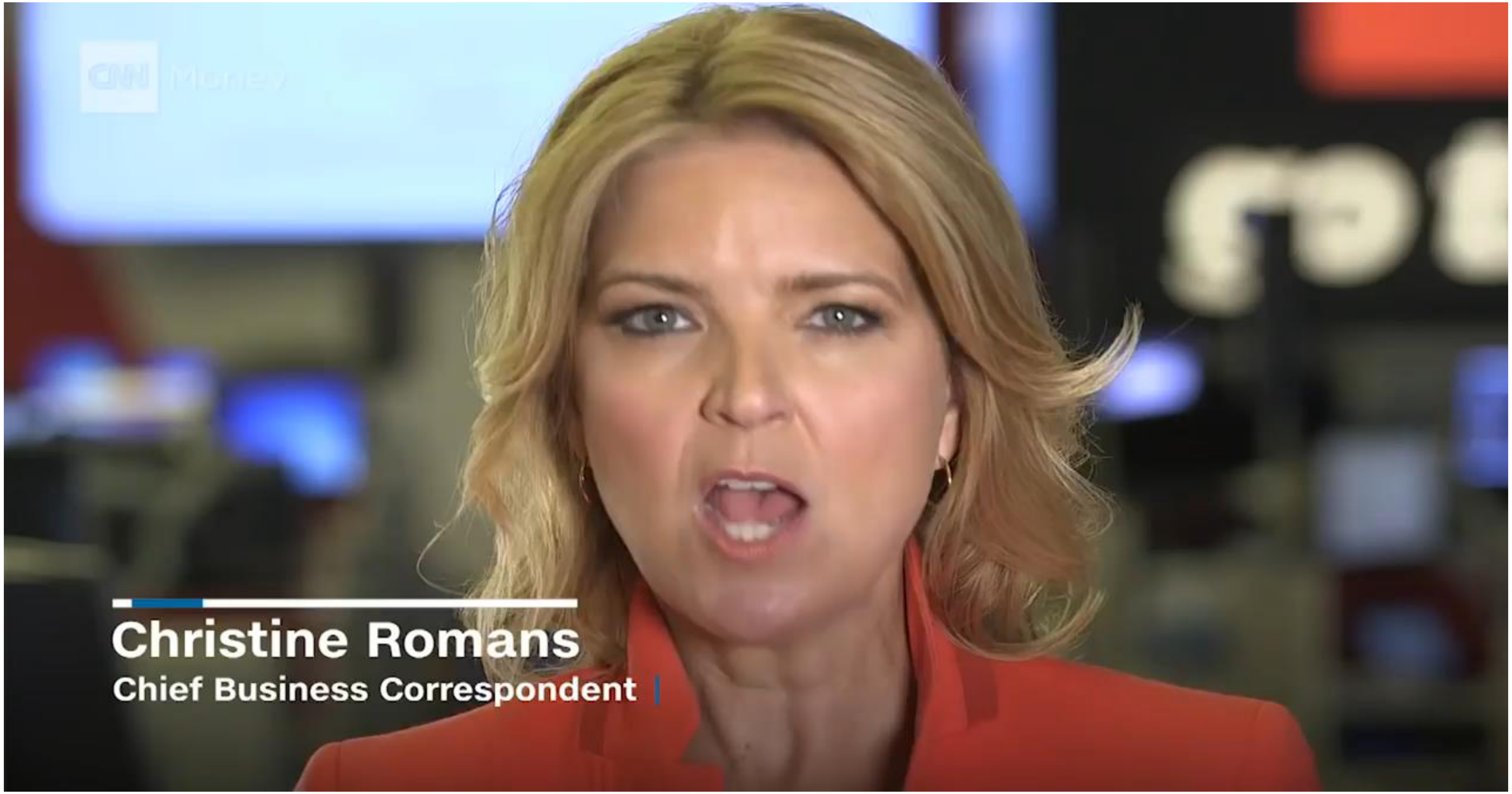
Examples of Corporate Scandals - Toshiba

- While Toshiba created an audit committee and appointed independent board members to it, the internal audit department reported to the company's president - with no routine access to the company's board of directors.
- Questioning or challenging actions of corporate executives is virtually impossible in traditional Japanese corporate cultures
- Indeed, this aversion to questioning authority was identified as a primary culprit to the overall problem.

Examples of Corporate Scandals - Toshiba

- When Toshiba's top executives set unrealistic performance (profit) goals, division presidents, line managers, and employees below them carried out inappropriate accounting practices to meet targets in line with the wishes of their superiors.
- The culture could have contributed to the internal audit department ignoring early findings of accounting irregularities.
- Various recommendations, including scrapping the existing internal audit function were made.

Examples of Corporate Scandals – Wells Fargo



Examples of Corporate Scandals – Wells Fargo

- ✓Staff at Wells Fargo 'opened more than 1.5 million unauthorised deposit accounts and applied for roughly 565,000 credit card accounts' according to the Consumer Financial Protection Bureau (CFPB).
- ✓Once the accounts were opened the employees transferred money to temporarily fund the new accounts which allowed them to meet sales goals and earn extra compensation.
- ✓In order to create sufficient funds to pay the premiums of this policy holders, it had to 'kill off' some of the policy holders and then, because it had funds it did not know what to do with, it created new policy holders.

Examples of Corporate Scandals – Wells Fargo

- ✓Just before the bubble burst the information indicated that they were insuring more people than resided in the US.
- ✓The 'scam' lasted 5 years and the bank was fined $185 million
- ✓Wells Fargo had to fire about 5,300 workers (out of a total staff estimated at 265,000, or 2% of all employees).

Key Lessons:

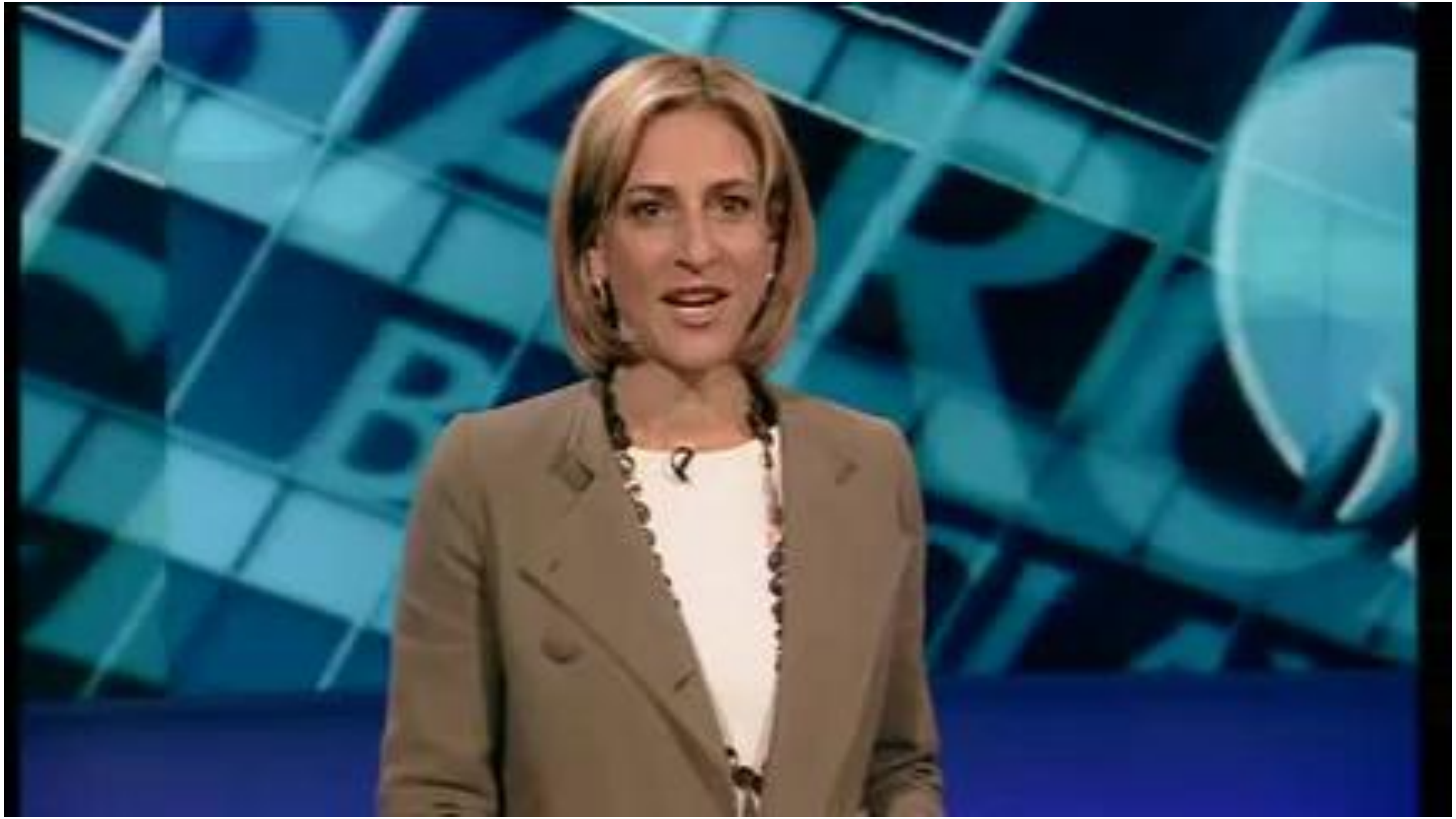
- ✓Unchecked incentives can lead to serious consumer harm, and that is what happened in the case of Wells Fargo
- ✓One of the questions to be asked: Where was internal audit?

Examples of Corporate Scandals – Wells Fargo

Key Lessons:

- ✓Pressure and incentives on sales goals are an important part of the culture of an organisation.
- ✓Messaging and communications to employees, especially informal ones, that sales targets must be met at all costs will often override those that encourage employees to do the right thing.
- ✓Pressure to achieve numbers caused employees to rationalize their fraudulent behaviour.

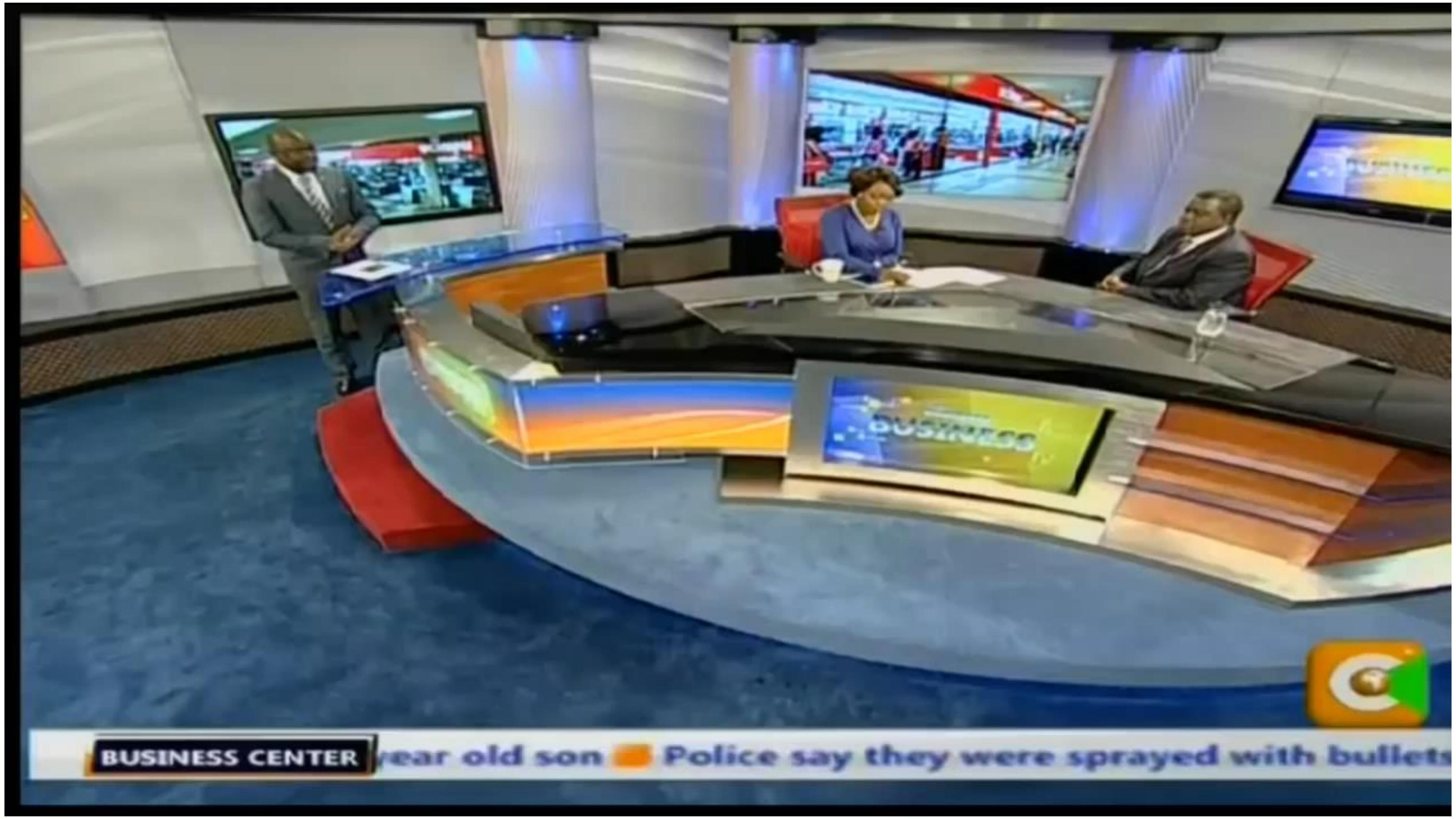
Examples of Corporate Scandals – Barclays



Examples of Corporate Scandals – Barclays

- ✓Employees manipulated the London Interbank Offered Rate (LIBOR), a key benchmark for global financial transactions, including payments on mortgages, credit cards and other financial contracts.
- ✓LIBOR is set daily by the British Bankers Association (BBA) based on submissions by banks of what they estimate they would have to pay for unsecured borrowings for periods of from overnight to one year.
- ✓In its filings, Barclays said its traders had communicated with its staff who submitted rates to the BBA, asking that the rates be adjusted to increase the traders’ chance of success on credit transactions.
- Barclays agreed to pay $453 million to settle charges by U.S. and UK authorities

Examples of Corporate Scandals – Uchumi



Examples of Corporate Scandals – Uchumi

❑ Allegations included:

1) Systematic plunder of the supermarket chain
2) Questionable procurement of goods and services, deals with financiers, and fraudulent payments to suppliers.
3) Manipulation of financial statements to hide losses
4) Fraudulent prospectus

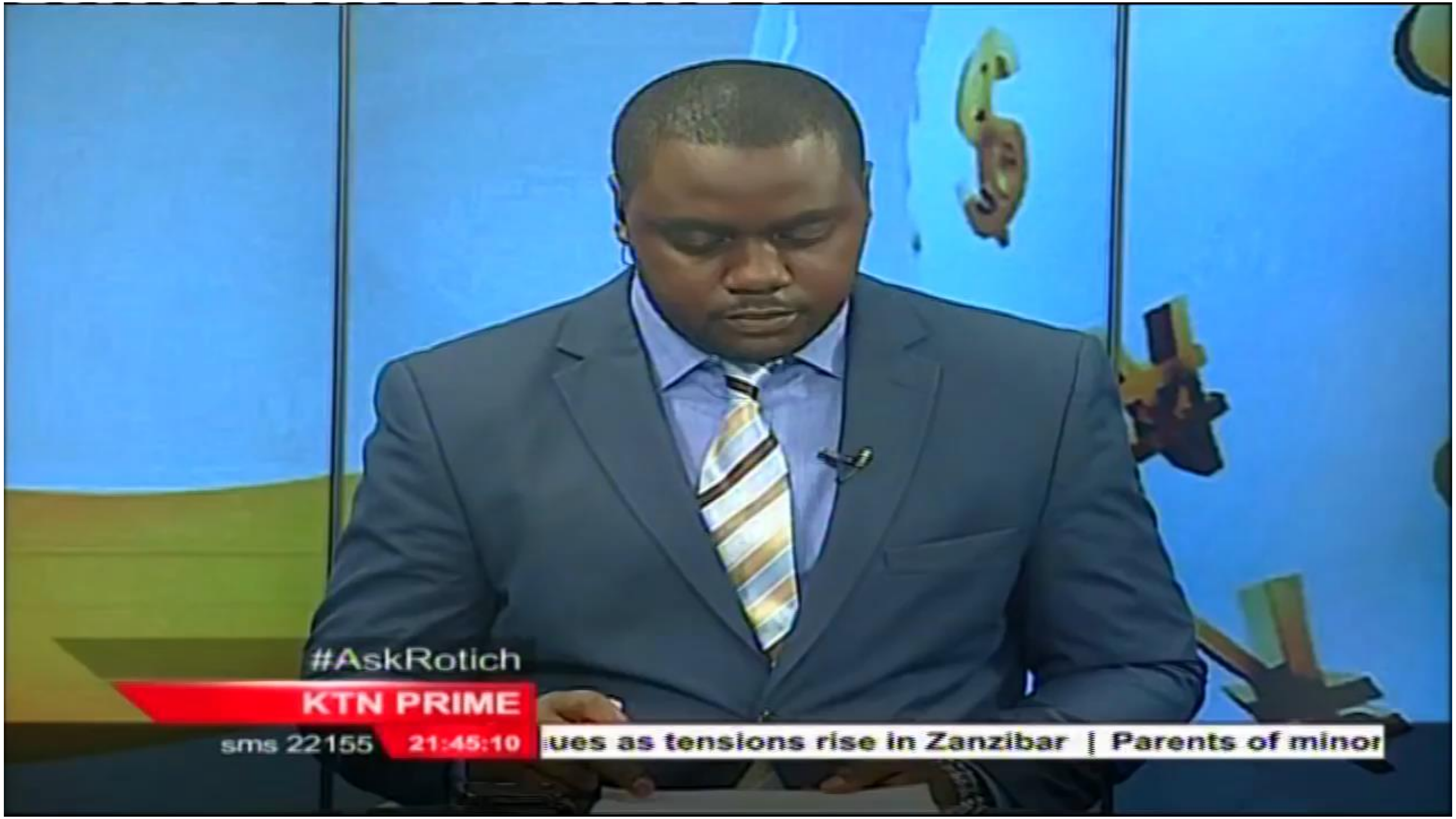
✓ failure to disclose a sale and lease-back agreement worth KSh1.6 billion

Examples of Corporate Scandals – Imperial Bank

❑Allegations included:

1) Irregular disbursemennt of loans running to billions of shillings to friends and business associates, concealed from the BOD
2) ‘Creative accounting’ to hide loans
3) Fraudulent transfer of deposits made by customers to various accounts and then withdraw or transfer. The transactions were concealed and did not appear in the financial statements
4) Irregulars loans to regulators in exchange for helping to hide unauthorized debt.

Examples of Corporate Scandals – Imperial Bank



Positioning Internal Audit to Deal with Corporate Scandals

1) The Internal Audit Function should be an integral part of the corporate governance system.

- ✓should be strategically positioned in order to achieve its objectives
- ✓Should report functionally to the audit committee
- ✓Section 3.5.4 of the Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya, 2002, requires the Board to establish an internal audit function.
- ✓IIA - CAE should report functionally to the audit committee, board of directors, or other appropriate governing authority

Positioning Internal Audit to Deal with Corporate Scandals

2) Internal Audit must maintain an up-to-date set of policies and procedures, and performance and effectiveness measures for the Internal Audit function.

✓ Internal Audit should continuously improve these in light of industry developments.

✓ the role of internal audit must be articulated in an Internal Audit Charter that is reviewed annually, possibly by a third party, in order to make sure that it is matching with the evolving best practices.

Positioning Internal Audit to Deal with Corporate Scandals

3) Carry out an assessment of the overall effectiveness of the governance, risk and control frameworks of the organization

- ✓ Should be done at least annually
- ✓ Should encompass an analysis of themes and trends emerging from internal audit work and their impact on the organization's risk profile.
- ✓ A comprehensive report is then presented to the audit committee and the board with the results and recommendations as well as the challenges that may need board interventions to handle.

Positioning Internal Audit to Deal with Corporate Scandals

4) The Chief Audit Executive and senior managers within Internal Audit, should have an open, constructive and co-operative relationship with regulators

- ✓The relationship should be aimed at supporting sharing of information relevant to carrying out internal audit responsibilities.
- ✓This should be done within the framework of corporate governance of the organization, the one that is approved by the board of directors and endorsed by the owners if necessary.

Positioning Internal Audit to Deal with Corporate Scandals

5) The internal audit should establish and maintain a quality assurance and improvement program.

- ✓Since the quality of the carrying out the internal audit function may have serious implications on the company and on its stakeholders
- ✓The results of the quality assurance work should be presented to the Audit Committee for review.
- ✓Should be done even where the internal audit function is outsourced

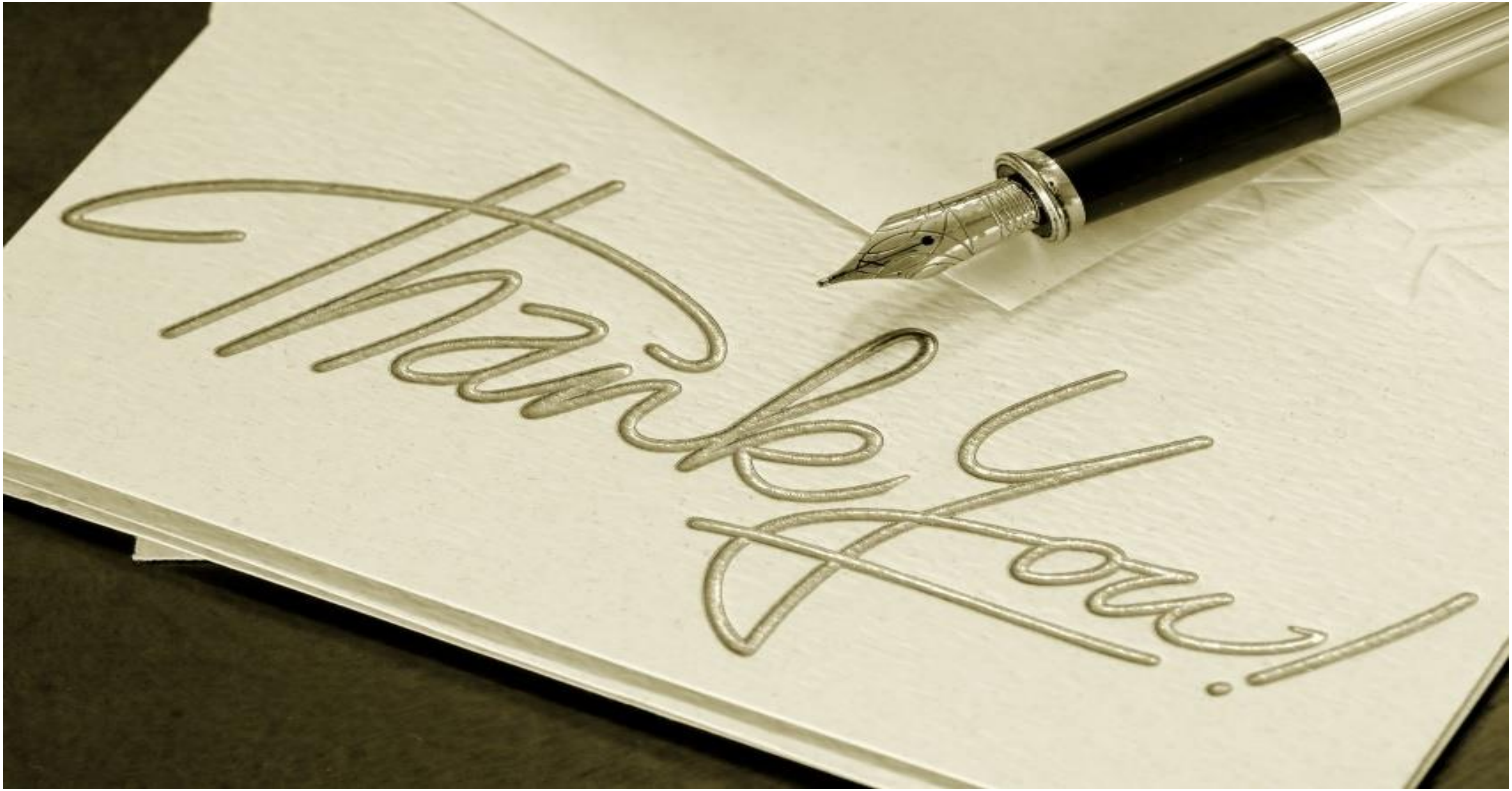
Positioning Internal Audit to Deal with Corporate Scandals

6) The internal auditors may have a responsibility in educating audit committees on what is important and the questions audit committees are supposed to raise at their meetings.

- ✓ Internal Audit acts as an important line of defense for any company and its failure may lead to the failure of the organization itself.
- ✓ The internal audit focus has shifted, it is not whether a control is being performed but whether it is the right control and if it is being performed correctly and cost effectively.

Conclusion

- There are many preventative measures that can be taken to stem scandals , but it is nearly impossible to fully extinguish them.
- Preventing opportunities, through internal controls or otherwise, is the most important part of the fraud triangle.
- Once an individual has established a rationalization and motive, they will commit the fraud once an opportunity presents itself.
- It is typically the highest individuals in an organization that have the power to commit the most damaging fraud.


Thank You!

RONALD W. WANYAMA
0724292399
ronnywanyama@yahoo.co.uk