BLIND SPOTS & ETHICAL DILEMMAS

In light of the corporate scandals, privacy invasions, compromised ethics and governance lapses; what should we be doing differently?

July 2019
Overview

ETHICS

01. Ethics as per the IPPF standards
02. Attributes of ethical internal auditors
03. Ethical Culture - Responsibilities
04. Blind spots & Ethical Dilemmas
05. Audit Considerations
1. ETHICS AS PER THE IPPF STANDARDS

**Standard 2110.A1** requires that IA activity evaluate the design, implementation, and effectiveness of the organization’s ethics-related objectives, programs, and activities.
The role culture plays in Business Ethics...

- is an integral part in the foundation of good governance
- sets expectations for acceptable behaviors in conducting business

“Behavior is influenced much more by culture than by rulebooks”…

Warren Buffet
EMPHASIZE the BASICS.
ELEVATE the STANDARDS.

Naohiro Mouri, 2018–19 IIA Global Chairman
Let’s get down to basics....

In executing their responsibilities, Internal Auditors are faced with conflicting situations where they must:

1. Make an ethical decision
2. Make difficult/uncomfortable inquiries
3. Face sensitive issues/political dilemmas
The purpose is to promote ethical culture...
IIA Code of Ethics

It is intended to **guide** the ethical conduct of internal auditors

- Principles
- Rules of Conduct
IIA Code of Ethics

- **Principle 1**: Competency
  - Knowledge, skills & Experience

- **Principle 2**: Objectivity
  - Balanced assessment

- **Principle 3**: Confidentiality
  - Respect information value

- **Principle 4**: Integrity
  - Establish trust and reliance
Internal auditors apply the knowledge, skills, and experience needed in the performance of internal audit services.
Principle 2

Objectivity

Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.
Confidentiality

Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.
Principle 4

Integrity

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.

“If you have integrity nothing else matters, And if you do not have integrity, nothing else matters”. 

- Harvey Mackey
Exercise 1

- Apply the code of ethics to internal audit decisions
Example: Apply the code of ethics to IA decisions

Through an audit of the credit department, CAE became aware of a material misstatement of the year-end accounts receivable balance. The external auditor has completed the audit without detecting the misstatement. What would the CAE do in this situation?

a. Inform the external auditor of the misstatement
b. Report the misstatement to management when the external auditor presents a report
c. Exclude the misstatement from the internal audit report because the external auditor is responsible for expressing an opinion on the financial statements
d. Perform additional audit work on accounts receivable balance to benefit the external auditor

Source: Powers Resources Corporation CIA Exam Review
Example: Apply the code of ethics to decisions

Through an audit of the credit department, CAE became aware of a material misstatement of the year-end accounts receivable balance. The external auditor has completed the audit without detecting the misstatement. What would the CAE do in this situation?

a. **Inform the external auditor of the misstatement** Correct – Rule of conduct 2.3 states: “Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of the activities under review.”

b. Report the misstatement to management when the external auditor presents a report

c. Exclude the misstatement from the internal audit report because the external auditor is responsible for expressing an opinion on the financial statements

d. Perform additional audit work on accounts receivable balance to benefit the external auditor

*Source: Powers Resources Corporation CIA Exam Review*
2. ATTRIBUTES OF ETHICAL INTERNAL AUDITORS

IIA Standard 1210 – Proficiency: “Internal auditors must possess the knowledge, skills, and other competencies needed to perform their individual responsibilities.”
Modern Internal Auditors must have... the state of mind and executive presence necessary to operate in today’s complex business world.

We have to be strategic...
We have to be firm...
We have to model desired behavior...
and we have to strive to become a trusted advisor...
Working to ensure things go right before they can go wrong

It takes courage to do the right thing

For the actions & resulting perceptions

Build a history of ethical behavior, so people can trust.

Treating others with respect and compassion

7 Attributes of Ethical Internal Auditors, Richard Chambers
3. ETHICAL CULTURE (Responsibilities)
Everyone should be an ethics advocate...

- **Board of Directors**: Build Governance Framework. Oversees the ethical climate, needs assurance.
- **Senior Management**: Set the Tone at the top. Foster Ethical Culture & monitor results.
- **Operations Management**: Promote Ethical Behavior. Exemplify and evaluate sub-culture in their area.
- **Employees**: Share Responsibility. Instill and promote integrity & accountability.

**Internal audit** must be viewed as a role model and an advocate of strong ethics.
Role of Internal Audit

Have **adequate business acumen** to identify unethical behaviors | Raise red flags if any unethical practices suspected | **AND** Exercise due diligence by following-up

Be trusted | **possess high level of integrity** | possess skills to be effective advocate of ethical conduct

Have the **competence to influence** the leaders and employees’ behavior to comply with the ethical responsibilities

Proactive and act as a catalyst for change

Perform independent and objective assessments to provide assurance that the governance structure is properly designed and operating effectively
Questions the Board should ask about an Ethics and Compliance program in their organization...

• Does the communicated tone-at-the-top demonstrate to employees that ethics and compliance are vital to continued business success?
• Does a reporting process exist to keep the board informed on ethics and compliance irregularities/breaches?
• How do we assess the effectiveness of the reporting mechanism used by employees to raise ethics and compliance issues without fear? Who follows-up on the concerns raised?
• Does management regularly and systematically scrutinize the sources of compliance failures and react appropriately?
• Does management take action on reports?
Exercise 2

– Provide examples of:
  • ethical violations
  • and reporting channels

– What is the impact of unethical behaviors?
Exercise 2 - Examples of Ethical Violations

• Corruption: bribing, favoritism...
• Fraud and theft or waste of resources
• Conflict of interest (gifts, sideline activities...)
• Abuse of power or authority
• Falsifying documents
• Misuse and manipulation of information
• Indecent treatment of colleagues/customers
• Undue sick leave
• Misconduct in private time
Exercise 2 - Reporting channels

- Hotline for reporting integrity/business ethics issues
- Line Manager/supervisor
- Incident Reporting System
- Human Resources Department
- Compliance/Legal/Internal Audit Department

Reporting channels should be accessible to all employees at all times (in writing and/or verbally). Employees must be informed and trained on the use of those reporting channels.
Exercise 2 - Impact of unethical behaviors

• Legal ramifications
• Financial damage
• Company credibility/reputation damage
• High level of risk, stress and conflict
• Lower productivity
• Stakeholders trust

“Trust takes years to build, seconds to break, and forever to repair.”
- SearchQuotes.com
3. ETHICAL CULTURE
(Contributing Factors)
“Don’t think there are no crocodiles, just because the water is calm.”
Malaysian Proverb
Historical data is showing upward trend...

Ethical lapses and Fraud schemes continue to evolve in complexity... and serious consequences...

Financial

Reputation

Socio-Political
Sources of ethical lapses = Opportunity + Judgement

(judgment influenced by greed, ambition, financial pressure...)

Employees might be reluctant to report ethical lapses due to:

- No clear reporting channels
- No concrete corrective measure
- Lack of anonymity
- Fear of retaliation
Important steps to prevent Ethical Lapses

Build a **culture of integrity from the top down** and lead by example

*Establish a code of conduct and a system of checks and balances to minimize opportunities for unethical behavior*

*Assess the employees’ understanding and adherence to the code of conduct*

Foster empowerment & interaction across the **hierarchy to raise concerns and express grievances**
Important steps to prevent Ethical Lapses

Support effective whistleblowing and grievance mechanisms and build trust in the integrity of the reporting system.

Ensure transparency, open communication and clear accountability, implement effective disciplinary measures.

Ensure company’s metrics don’t create pressure that influence employees to cut corners.
4. BLIND SPOTS AND ETHICAL DILEMMAS

1100 – Independence and Objectivity: “Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made...”
Ethical Dilemmas

“Grey area” situations with no pre-defined answers. Employees have to “invent” the solution.

Difficulty in deciding is not choosing between the right or wrong, but rather from being forced to choose from a “not-so-perfect” set of options. Choosing the “best-of-the-worst”
Ethical decisions in IA engagements...

UNDERSTAND
• Get your facts straight
• Reliable information to accurately determine and assess the ethical dilemma from all perspectives

ANALYZE
• Possible course of action
• No approach will provide an automatic solution to the ethical dilemma

RESOLVE
• Show your strength of character
• Do you have what it takes to behave in an ethical manner despite the potential negative repercussions?
Sample – Ethical Checklist

Ethical Checklist of the Chartered Institute of Management Accountants (CIMA)
Example: Apply the code of ethics to decisions

An internal auditor who encounters an ethical dilemma not explicitly addressed by the IIA Code of Ethics must always:

a. Seek counsel from an independent attorney to determine the personal consequences of potential actions
b. Take action consistent with the principles of the IIA Code of Ethics
c. Seek the counsel of the audit committee before deciding on an action
d. Act consistently with the organization’s code of ethics even if such action would not be consistent with the IIA Code of Ethics

Source: Powers Resources Corporation CIA Exam Review
Example: Apply the code of ethics to decisions

An internal auditor who encounters an ethical dilemma not explicitly addressed by the IIA Code of Ethics must always:

a. Seek counsel from an independent attorney to determine the personal consequences of potential actions

b. Take action consistent with the principles of the IIA Code of Ethics — Correct: This is consistent with the concepts embodied in the IIA Code of Ethics

c. Seek the counsel of the audit committee before deciding on an action

d. Act consistently with the organization’s code of ethics even if such action would not be consistent with the IIA Code of Ethics

Source: Powers Resources Corporation CIA Exam Review
Motivated Blindness

The closer you are to a person

More likely to

- Overlook their misbehavior
- Deny that it is a misbehavior
- Come up with justifications for their misbehavior

“Motivated Blindness” is unconscious, common and contributed to failing to noticing the corruption
Blind Spots

• Best practice policies, procedures and systems alone are not enough.

• Sometimes good people will do bad things when under pressure; and then rationalize their misconduct as acceptable.

• Red flags / signals often exist—finding them and joining the dots require broad and inquisitive thinking.
RED FLAGS INDICATORS

- Increased customer complaints
- Aggressive forecasts
- Regular profit warnings
- Liquidity problems
- Key documentation missing

- Rarely takes holiday
- Lifestyle/income mismatch
- Autocratic management style
- Obsessive secrecy
- Bullies/intimidates colleagues

- Lack of segregation of duties
- Frequent change of auditors
- Lack of clear reporting lines
- Undisclosed private business by employees

- Culture of favoritism
- High staff attrition
- “Results at all costs” attitude
- Minor but regular failures
- Passive staff turning blind eye

Source: Study by KPMG on Ethics and Integrity, Blind spots & Red flags
5. AUDIT CONSIDERATIONS

*Standard 2110.A1* – “The internal audit activity must evaluate the design, implementation, and effectiveness of the organization’s ethics-related objectives, programs, and activities.”
Audit considerations

1. Conduct an entity-wide survey
2. Audit of ethics-related policies, activities and functions
3. Use a Maturity assessment Model
4. Ensure that fraud risk exposure is assessed periodically, and suitable fraud prevention and response plan is in place
5. Include the risk of fraud in the audit plan and in each audit assignment (assess the related controls)
6. Have a high-performing audit team capable of:
   - Identifying red flags indicating fraud may have occurred
   - Understand the characteristics of fraud schemes/scenarios and the techniques used
   - Evaluate the indicators of fraud and decide whether if action/investigation is necessary
   - Evaluate the controls effectiveness aiming at preventing / detecting fraud
KEY TAKEAWAYS

Getting the right ethics and integrity embedded within a business is a complex process.
Summary - Main Contributing Factors

1. Culture of Integrity
2. Strong tone-at-the-top
3. Code of Conduct
4. Improved Communication and training
5. Effective whistleblowing process
6. Sound corporate governance
7. Ethical metrics
Thank You!

Colette Harb
Consultant, UAE IAA
Email: colette@uaeiaa.org
Tel: 00971506959005