Management Advisory Services & Consultancy International
Looking Back, To Keep On Track
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- MN Vikings Party Boat (2005)

- Sport scandals
  - NFL Player conduct controversy (2007-present)
  - NE Patriots Spyv Gate (2007)

- Government scandals
  - Edward Snowden and NSA leaks (2013)
  - Representative Dennis Hastert
Outline

• Two major corporate scandals, VW and FIFA

• Lessons for Internal Auditors from the VW and FIFA scandals

• Common Mistakes IAs make, and suggestions
The VW Scandal - Background

• In 2011, Martin Winterkorn, then CEO of Volkswagen, drafted a very ambitious plan to overtake Toyota as the world’s largest auto manufacturer

• The plan called for tripling overall sales of vehicles in the U.S. by aggressively marketing diesel-engine powered vehicles as alternatives to hybrid-style vehicles

• Senior managers, not directly responsible for implementing the plan, fully supported the CEO’s plan. Mid-level managers were tasked with implementation of the objectives set by Senior Management

• The marketing people, working on their own, were trying to sell VW cars as a green car
• VW sold upwards of 500,000 diesel engine vehicles in the U.S.

• In 2014, Volkswagen was caught cheating the U.S. EPA emissions controls standards:
  o by manipulating software within its diesel engine vehicles to ‘trick’ emissions testing equipment, to falsely produce a pass rating

• VW equipped roughly 11 million vehicles worldwide with this software that could be used to cheat on emissions tests
VW Scandal – The Reality

• The scandal:
  a) it happened in such a very well-established and apparently well-managed company with a great brand
  b) it involved deliberate and unmistakable deception
  c) it seems very obvious that it was going to come to light at some point

• The allegations and subsequent confirmation by company executives have severely damaged public confidence in the iconic company

• Volkswagen reserved over 6 billion euros to cover the expected costs of this scandal
The VW Scandal

• Martin Winterkorn, CEO of Volkswagen, resigned, expressing shock that misconduct on such a scale could happen at the company. He later admitted to bypassing the emissions control standards and tendered his resignation.

• VW’s official line was that this was the result of the actions of a few engineers and IT programmers.

• As reported by CNN, the diesel engine cheat was discovered in 2014 by a laboratory that was retained by a clean air advocacy group that had issues with emissions levels in diesel engine vehicles produced by Volkswagen.

• In 2014, Volkswagen had sold 11 million vehicles globally, ahead of Toyota and GM, and had taken-in over 200 billion euros ($225 billion USD) in global revenues.
VW’s CEO had a pay package that was heavily tilted towards variable pay
- In 2014, he took home €16m ($18.3m), of which only €2m ($2.3m), or 12.5%, was fixed compensation. The heavy tilting towards performance related pay was common across members of VW’s Management Board.

The variable pay was not tied directly to the share price, but was linked closely to a number of metrics including operating profits, sales growth, customer satisfaction and employee productivity and satisfaction
- This was consistent with the publicly-announced goal for VW for many years, namely growth: the goal was to make VW the largest car maker by sales in the world.
VW’s Supervisory Board (common in Germany) of 21 had:

- 5 members appointed by the Porsche family, the controlling shareholder
- 2 appointed by the Qatar Sovereign wealth fund (which holds a 17% stake)
- 2 appointed by the state of Lower Saxony (holding a 20% stake)
- 10 appointed by employees, trade unions, and middle management
- 2 comprised the Supervisory Board’s former Chairman, and a single independent

Growth was an ambition that pleased all stakeholder groups of the Supervisory Board, the controlling shareholders and the employees

The bias toward performance pay was shared by all members of VW’s Supervisory Board
• Back in the 1970's, the U.S. was the first country to begin regulating vehicle emission pollutants. Volkswagen being a small player in the U.S. at the time, was one of the first auto manufacturers to be caught using a cheating device to falsify vehicle emissions testing. The company was fined $120,000.

• In the late 1990's, truck engine manufacturers were fined $1 billion USD for doing the exact same thing Volkswagen has just admitted to — using software to cheat on vehicle emissions testing.
The VW crisis is the result of a three-pronged governance and culture failure.
Marketing: is about driving sales, and positive environmental messages are a sales person’s dream.

VW sales team started advertising their diesel vehicles as ‘green’ cars.

Risks:
• In the process of marketing products there can be a tendency to brag in order to increase sales. With environmental issues there is always a danger that the promises of salesmen are only PR gimmicks

• When such marketing approaches and promises are found to be incorrect, consumer mistrust and reputation loss follow. Rebuilding trust, is a long and hard process
**Risk management process:** VW apparently did not look beyond financial and operational risks

**Risks:**

- Risks very often come from social and environmental issues, and ethical concerns (non-traditional risks). They often don’t appear on the radar because they are hard to identify, quantify and manage.

- Historical risks are often not considered while assessing current risks.
Internal control and audit: Governance systems at VW were obviously deficient

Risks:
- Absence of governance systems including internal controls to address non-traditional risks that could have a big financial impact, particularly where there is an incentive for manipulation
Governance and Culture Failure

The true risk landscape can be seen only when the three parts are connected together.

A combined look at these three parts, changes the risk landscape significantly.
The invisible lines ..... for connecting the dots

- The plan to overtake Toyota as the world’s largest auto manufacturer, and tripling overall sales of vehicles in the U.S. was made at a time in the U.S. where emissions standards were becoming more and more aggressive due in large part to the Obama Administration’s clean environment agenda.

- The marketing people working on their own trying to sell a car as a green car is not such an issue, but when you link that to the potential for manipulation elsewhere in the organization (operations) in order to increase sales, the risk profile seriously changes.

- Creating a high performing, fuel efficient diesel vehicle, that is good for the environment, and that makes money, is very difficult.
The invisible lines ..... for connecting the dots

• A corporate mentality of ‘getting-the-job-done-at-any-cost’, would, in all probability, have made the work environment at Volkswagen Engineering very stressful, especially for mid-level management.

• Middle-managers would have realized that they are fully replaceable by the next job candidate who will get the job done in some way. The tendency thus arises to ‘cut corners’ whenever problems arise.

• The fraud triangle has three elements – Pressure, Opportunity, Inclination to Rationalize.
Connecting the Dots to View the Real Risk Landscape

Objective/Target of tripling sales

Aggressive US emission standards

Operations team: Fuel-efficient, clean-air and profitable cars

Marketing people promoting green cars

Senior management support

Historical background

Board comprising “interested parties”

Corporate Mentality – ‘Just Do It’

Heavy tilting towards performance-based pay of CEO

Historical background

1. Aggressive US emission standards

2. Operations team: Fuel-efficient, clean-air and profitable cars

3. Objective/Target of tripling sales

4. Marketing people promoting green cars

5. Middle management – Deliver Business Objective
Lessons learned

1. The Cobra Effect

Where revenue generation and cost management initiatives are highly incentive-driven, Risk Management and Internal Audit should be aware of the “Cobra Effect”

The “cobra effect” is when individuals perform based on misaligned incentives, that ultimately jeopardize their organization’s mission
Lessons learned

The Cobra Effect ......

• Have a centralized risk management function that assesses risks across all departments/functions – to know what’s happening across the business. The Board needs to set the right tone for this

• Internal Audit should report indications of ‘Cobra Effect Culture’ to the Audit Committee and the Board

• Internal Audit should provide assurance on the adequacy and effectiveness of controls to protect against possible means of manipulation
2. Reputational Risk

• Avoiding reputational problems is not just about proper functioning of each of the functional areas, like marketing, risk management, internal control and audit. It is also about synchronization between these functions

• Major reputational threats should be incorporated into the Risk Register

• Internal Audit should take a holistic view while identifying and assessing risks

• Internal Auditors should graduate towards providing “Combined Risk Assurance”
3. Environmental Compliance

• Companies are getting better at monitoring environmental compliance, and other possible sources of reputation risk, e.g. in their Supply Chain function. They need to have appropriate internal controls over such matters in their own operations.

• Internal Audit should be monitoring for compliance breaches and other unethical behavior.
Lessons learned

4. Composition of Board of Directors

• If the Board comprises of mainly interested parties, highly “ambitious business decisions” could remain unquestioned. Significant risk could arise from a high likelihood of conflict of interest to question anything that might have a negative impact on short-to medium-term revenue, profitability and dividend payouts.

• Having someone from outside, i.e. independent directors, looking in, is sound business practice. At times boards need to be challenged and questioned.

• Having a positive boardroom culture where different views are respected and allowed to be discussed, can play a big role.

• Where bringing-in independent directors may not be an option, Internal Audit should coordinate with Risk Management to ensure adequate controls exist over the decision-making process.
5. Internal Audit status and resourcing

• Companies should maintain a well-resourced internal audit function that is organizationally independent from operating management and serves as a key source of assurance on the effectiveness of risk management and internal controls.

• When a risk management or control failure strikes at the reputation of a high profile organization, the public seeks the truth. They will not be persuaded until someone who is not implicated in the failure, offers an assessment or explanation. Unless criminal activity is involved, internal audit should be involved to get to the truth.
• The results of internal audit's review disclosed, "... that procedural problems encouraged misconduct"

• The Chairman took great pains to note that internal audit did not identify any involvement of executive board in the scandal. Instead, it concluded that the cheating software was the result of the actions on the part of a group of employees and that inadequate compliance procedures fueled the deception for years

• VW used internal audit reports to begin restoring public confidence, an example of the credibility of the internal audit profession
Lessons learned

6. Thorough Business Knowledge

- Internal Auditors need to have a thorough and detailed knowledge of their organization’s business and of their related industry
  - Back in the 1970's, the U.S. was the first country to begin regulating vehicle emission pollutants. Volkswagen was one of the first auto manufacturers to be caught using a cheating device to falsify vehicle. The company was fined $120,000.
  - In the late 1990's, truck engine manufacturers were fined $1 billion USD for doing the exact same thing Volkswagen has just admitted to — using software to cheat on vehicle emissions testing.
  - A large electronics supplier, Bosch, warned Volkswagen back in 2007 that using certain emissions controls electronics in “cheat mode” should only be used for testing and quality control purposes and should be disengaged once vehicles were manufactured.
  - Volkswagen, obviously ignored the warnings. In 2011, an internal whistleblower notified the company of irregular activities occurring with emissions testing control systems.

- Historical knowledge of high risks, goes a long way in identifying risks that may not be apparent, or identifying risks of a highly technical nature. Audit resources can accordingly be assigned to higher risk areas.
Lessons learned

7. Organizational Culture Audits

• Very high sales targets, given significant technical challenges, causes a very stressful work environment, especially for mid-level management

• An experienced internal audit team that is truly independent should be able to pick up on this type of toxic corporate culture and adjust their audit procedures and plan accordingly. And more importantly, communicate their observations to the Board of Directors

• Internal Audit needs to guard against becoming a part of the toxic culture, and buy into it
The FIFA Scandal
An Overview
June 2015: The U.S. Department of Justice (DOJ) announced charges and arrests for "rampant, systemic, and deep-rooted" corruption by high-ranking members of FIFA, the sport's global governing body.

Using the U.S. Foreign Corrupt Practices Act (FCPA) as its legal hammer, the DOJ outlined in its 47-count indictment a disturbing history of alleged bribes and racketeering by top FIFA officials dating back as far as two decades.

The investigation centers around deals made between FIFA officials and sports marketing executives, who are alleged to have systematically paid and agreed to pay well over $150m bribes and kickbacks to obtain lucrative media and marketing rights to international football tournaments.
FIFA’s IA function

FIFA had an Audit & Compliance Committee with the following mandate:

- The Audit and Compliance Committee shall ensure the completeness and reliability of the financial accounting and review the external auditors' report at the request of the Executive Committee.
History of allegations against FIFA

- October 20, 2010: FIFA executives are suspended over allegations they were ready to sell their vote for the 2018 and 2022 World Cups
- November 29: New corruption allegations against executives representing Brazil, Paraguay and Cameroon
- December 6: FIFA vice-president is accused of having received US$67 million in bribes from a prospective World Cup host country
- May 10, 2011: Former FA chief accuses FIFA vice-presidents representing Trinidad and Tobago and Thailand, to have made illegal demands ahead of the World Cup vote.
1. Internal audit must raise a ‘yellow card’ when corporate culture creates susceptibility to corruption

• FIFA President Sepp Blatter was the organization's president, and he has said he knew nothing of the alleged corruption

• But allegations of corruption within FIFA were not unheard of before the DOJ indictments
  o The bottom line is that no organization can afford to practice "willful ignorance" about serious challenges for long without paying a high price

The lesson for Internal Audit: A frank and honest analysis of corporate culture must be part of internal audit's purview, and it must raise its voice when erosion of the culture becomes an organizational risk
Lessons IA can learn

2. Internal Audit must act quickly to address reputational risk

- A number of media accounts of the evolving scandal have described long-held concerns about corruption at FIFA. FIFA's internal audit function should have identified and brought to management and the board of directors, the potential for significant reputational harm.

The lesson for Internal Audit: The internal audit function cannot afford to allow risks to organizational reputation to go unchallenged.

A secondary lesson is that reputational risk is not just about your organization. The behavior of the organizations you partner with, can impact your reputation as well.
3. Internal audit must play a significant role in crisis planning and execution

• Internal audit's role in crises cannot be one of simply assessing after the fact how a crisis plan was carried out. Internal audit can and must provide insight into the development of such plans, and be consulted even as a crisis is unfolding

*Lesson for Internal Audit*: Internal Audit must assess all risks — including the risks of not addressing adversity swiftly and effectively
Lessons IA can learn

4. Internal Audit must stay current with anti-corruption legislation

• Changing legal landscapes in the countries where the Company does business can develop into risks if the organization does not keep abreast of those changes. E.g.
  o Foreign Corrupt Practices Act (FCPA)
  o UK’s Anti-Corruption & Bribery Act

Lesson for Internal Audit: Internal Audit functions must be cognizant of growing anti-corruption efforts worldwide. This is especially important for businesses that operate globally
5. Internal Audit must be courageous

It is not hard to imagine that anyone within FIFA, charged with assurance on the effectiveness of compliance and controls, must have been under great pressure. The issue of courage for Heads of Internal Audit is a recurring theme.

*Lesson for Internal Audit:* Those aspiring to be CAEs must have the courage to do what needs to be done or say what needs to be said, no matter the consequences.

No corruption is acceptable, and nothing is off limits. This may be the most important lesson from the FIFA scandal, and one Internal Audit must embrace.
13 Mistakes that Internal Auditors normally make

Source: Internal Audit Mastery – IAM004
13 Mistakes that IAs normally make... and suggestions

1. Failure to manage/educate the Audit Committee

The Audit Committee members are busy and important, so we tend to limit what we share.

So, what information should we share with the Audit Committee?

• Four must-share things are:
  1) Your progress since the last reporting
  2) The significant issues identified during the period
  3) The status of significant issues identified in prior periods
  4) Any outstanding key risks left to be addressed by management

• Internal Audit should provide the Audit Committee with information about developments in the internal audit profession
2. Not investing in training

- There are numerous times when the client feels the auditor does not have good business acumen. Business acumen is often overlooked in department training programs.

- As stated by Richard F. Chambers in Lessons Learned on the Audit Trail, “It’s not enough to be a continuous learner; we must also ensure we are learning the right things. Too many internal auditors concentrate on a narrow range of specialized knowledge, but to advance into internal audit management requires a deep understanding of a wide range of business and industry practices.”
3. Not developing soft skills

• This may be the single most career limiting mistake internal auditors make

• Auditors tend to focus on the work (and only the work). Communication, People management, Relationship Building, etc. are essential IA skills that many internal auditors lack or do not even consider.
13 Mistakes that IAs normally make... and suggestions

4. Micromanaging engagements

- Micromanaging every engagement leads to a high staff turnover rate

- Audit staff don’t feel they are adding value, so they move on. This further reduces effectiveness as IA is constantly re-hiring
5. Not doing enough planning

• Engagement planning is such a critical part of the audit. Auditors should spend 60% to 70% of the engagement time in planning

• If the audit client knows the control is not effective, then Internal Audit shouldn’t be performing audit work
  • Instead, they should be performing a consulting engagement to help management get to the root cause
  • Don’t tell them what they know, help them fix it
  • This requires investing time in planning
6. Scope creep

- Proper planning makes managing this a lot easier, but it can still happen

- But what happens when we find something significant, and it wasn’t in our plan?

- At that point, there are 3 choices:
  1) Ignore it (but not likely if the issue is big enough)
  2) Scope it in (but only if it can be done within a reasonable budget tolerance)
  3) Document it and decide with the CAE/client where, when and how to address it
7. Not getting and maintaining client engagement

- When does an audit engagement end?
  - Never

- Spending time with your client only when you’re auditing that client, is not good engagement

- Audit clients have issues and risks to deal with each and every day. Keeping in touch regularly with audit clients, provides more opportunities to add value
8. Not engaging upstream and downstream management

- The client believes they completely understand the process, but very often, they don’t know what goes into the process before or after.
- Once you engage the client through the full process, you are able to better communicate the issues.
- In documenting a process, ask IA staff to track the full set of relevant inputs and outputs to understand how they all interact – a Flowchart/narrative helps.
- The upstream and downstream management can often provide valuable insight into proposed solutions to issues identified during the audit.
9. On the Ground, not On the Phone

The audit being done is a huge opportunity to interact with people in the company.

Being on site gives internal auditors a better opportunity to learn about the business and build relationships.

This cannot be done by just communicating with the client over the phone (Armchair Auditing).
10. Not properly using data

- If there is data, use the data to perform analyses

- Where possible, validate the data using other data sources

- Make sure you do enough work to support the audit conclusions. Extrapolating results to reach conclusions, could often result in incorrect findings and reputation risk for auditors
11. Massive audit reports

• Long audit reports are a pain to draft and read

• Ensure the findings are clear and concise

• Executive dashboards that give a full overview in a single page, are hugely effective. The detail could be in the back of the report if required
12. Shocking and significant findings

• Significant findings, presented by themselves, lack impact

• For greater impact, provide a path to closure, especially when presented to the Audit Committee and Senior Management

• Most important; make sure you are 100% right
13. Forgetting to add value

• Adding value is a part of the definition of Internal Auditing. But many auditors get stuck on the execution issues, and lose sight of the greater opportunity

• They often look for the easy solution. However, if they were to do a root cause analysis, the problem could be entirely different

• Reporting an issue that management already knows, is not adding value. Partnering with management to resolve the issue is a great way to add value
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