Internal Audit’s Responsibility for Impacting Governance

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Managing Director – CAE Solutions
The Institute of Internal Auditors, Inc.

Agenda

• Setting the stage
• Emerging risks, cutting through the fog of distractions
• Bringing transparency to culture issues
• Technology - seeing the real risks
• Engaging the board
• The Modern Internal Auditor
How Global CEOs See the World in 2018

• Majority anticipate improved global economic growth
• But still see threats to that growth

<table>
<thead>
<tr>
<th>Top risks</th>
<th>Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Over-regulation</td>
<td>42%</td>
</tr>
<tr>
<td>2. Terrorism</td>
<td>41%</td>
</tr>
<tr>
<td>3. Geopolitical uncertainty</td>
<td>40%</td>
</tr>
<tr>
<td>4. Cyber threats</td>
<td>40%</td>
</tr>
<tr>
<td>5. Availability of key skills</td>
<td>38%</td>
</tr>
<tr>
<td>6. Speed of technological change</td>
<td>38%</td>
</tr>
</tbody>
</table>

• Heightened risks
  – Neither terrorism nor cyber threats were in the top 5 at the beginning of 2017
  – Talent and technology are significant risks

Source: From PwC’s 21st CEO Survey: The Anxious Optimist in the Corner Office © 2018 PwC
North American Board Directors

What five trends do you foresee having the greatest effect on your company over the next 12 months?

<table>
<thead>
<tr>
<th>Trend</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Significant industry change</td>
<td>58%</td>
</tr>
<tr>
<td>Business model disruption</td>
<td>46%</td>
</tr>
<tr>
<td>Changing global economic conditions</td>
<td>46%</td>
</tr>
<tr>
<td>Cybersecurity threats</td>
<td>38%</td>
</tr>
<tr>
<td>Competition for talent</td>
<td>36%</td>
</tr>
</tbody>
</table>

(Could select five of seventeen risks listed)

NACD 2017-18 Public Companies Governance Survey

Disruption on the Horizon

NACD 2017-2018 Public Company Governance Survey
- Lists significant industry change, business model disruption, and technology disruption as some of the most likely trends over the next year

McKinsey
- Roughly one in three directors indicate their business models will be disrupted in the next five years.

NC State University ERM Initiative
- The rapid speed of disruptive innovations and new technologies is the top-rated risk for 2018.
Seeing Risks on the Horizon

“This world keeps spinning faster into a new disaster…”
Lady Antebellum – “Run to You”

Ways of Identifying Risks

• Use risk register – audit universe
• Interview executives on “what keeps them up at night”
• Consider issues identified in past audits
• Consult the experts in the field
Other Ideas for Risk Identification

- Consider non-traditional metrics that are used by management
- Look outside more than inside
- Talk to the top, middle, and bottom
- Respond immediately to something unexpected – understand it
- Always drive to root cause
- Keep looking at the horizon

Culture
What Lies Beneath…

Can Be A Major Issue
Culture Is Increasingly the Culprit in Organizational Debacles

**The Wall Street Journal**

**Volkswagen Pleads Guilty to Criminal Charges in Emissions-Cheating Scandal**

Volkswagen AG pleaded guilty to criminal charges for targeting developing countries and emulating their technology, causing the European Union to crack down on the company. The criminal charges, announced Tuesday, came after a year-long investigation by the U.S. government and its European counterparts.

**Wells Fargo to Claw Back $75 Million from 2 Former Executives**

Wells Fargo’s board voted Monday to reduce claw back in addition to the $75 million in compensation from the two executives in whose hands the company’s board of directors had placed responsibility for the scandal. The board also voted to remove the two executives, John G. Stumpf and his former head of community banking, Carrie L. Tolstedt.

**The Washington Post**

**Uber Founder Travis Kalanick Resigns as CEO Amidst Shareholder Revolt**

After several tumultuous months that culminated in a shareholder revolt, Uber’s board of directors on Tuesday ordered co-founder Travis Kalanick to step down as chief executive of the ride-hailing giant. The decision comes just days after the company’s board of directors met with Kalanick to discuss the company’s direction. The meeting was reportedly held in response to continuing pressure from shareholders, including funds of the company’s founder’s largest shareholder.

What is Culture?

“Shaped by formal and informal”

“Values and how they are translated into actions and outcomes”

“Behaviors employees have learned over time that work best for them”

“Unique component of every organization’s personality”

“You get trained by the culture you are in”
CEOs and CFOs See Culture As Critical

- Over 90% believe culture is important
- 92% believe improving their culture would improve value of the company
- Over 50% believe culture influences:
  - Productivity
  - Creativity
  - Profitability
  - Firm value and growth rates
- Yet, only 15% believe their corporate culture is where it needs to be

CAEs Grasp the Risks – But What Are We Doing?

- 89 percent of audit leaders said they understand the risks associated with culture
- But, 72 percent say they do not audit culture
- Auditing governance and culture was expected to account for 4 percent of the average North American audit plan in 2018

Source: "Corporate Culture: Evidence from the Field," Graham, Harvey, Popadak, and Rajgopal; Duke University, 2015
Legal and/or Compliance Objections

• “This is not your area. Legal is responsible for governance, including culture”
• “As a compliance function, we know better how to handle these sensitive topics”
• “You can’t write that down; it is a roadmap to getting sued”
• “Any issues need to handled under legal privilege”
• The report refers several times to employment lawyers who handled cases involving employees who were fired for sales misconduct, and who claimed they were following orders from supervisors. But the lawyers simply settled the cases. This lack of lawyer awareness of a larger problem continued through much of 2016, the report said.
Technology Risks

My Technology Journey

Fax Machine (early 1980s)

Lotus 1-2-3 (1983)

Email (1990s)

Data Analysis Software (Late 1990s)

TeamMate (Late 1990s)

EMAIL

CCH TeamMate
Audit Management System

DYL acl

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## Areas to be Impacted by AI

<table>
<thead>
<tr>
<th>Industry</th>
<th>Rank 1</th>
<th>Rank 2</th>
<th>Rank 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technology, Media, Telecom</td>
<td>Information Technology</td>
<td>Customer Service</td>
<td>Marketing</td>
</tr>
<tr>
<td>Consumer</td>
<td>Supply Chain Management</td>
<td>Sales</td>
<td>Marketing</td>
</tr>
<tr>
<td>Financial Services</td>
<td>Customer Service</td>
<td>Finance/Accounting</td>
<td>Information Technology</td>
</tr>
<tr>
<td>Professional Services</td>
<td>Strategy</td>
<td>Information Technology</td>
<td>Marketing</td>
</tr>
<tr>
<td>Health Care</td>
<td>R&amp;D</td>
<td>Operations/Manufacturing</td>
<td>Information Technology</td>
</tr>
<tr>
<td>Industrial</td>
<td>Operations/Manufacturing</td>
<td>Supply Chain Management</td>
<td>Information Technology</td>
</tr>
<tr>
<td>Energy</td>
<td>Operations/Manufacturing</td>
<td>Information Technology</td>
<td>Supply Chain Management</td>
</tr>
<tr>
<td>Public Sector</td>
<td>Information Technology</td>
<td>Customer Service</td>
<td>Operations/Manufacturing</td>
</tr>
</tbody>
</table>

**Overall**

- **Operations, including Manufacturing, SCM, and R&D**
- **Information Technology**
- **Customer-facing Functions**
- **Corporate Center Functions**

**Functional areas that were not in the top three of any industry: communications, human resources, legal or compliance, procurement**

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## IIA’s AI Auditing Framework

- **Three Components**
- **Seven Elements**

**AI Strategy**

- Cyber Resilience
- AI Competencies

**Governance**

- Data Quality
- Measuring Performance
- Data Architecture & Infrastructure

**Human Factor**

- Ethics
- The Black Box
In Substance, Just Like the Olden Days…

DATA
- Structured data, speech, text, optical patterns, objects

PROCESSING
- Offering: products and services
  - Processes: vertical and horizontal

ACTION
- Physical agents, digital agents, communication

Source: BCG analysis.

- We do not have the luxury to wait until the dust settles to get engaged
- Cannot be bashful or hesitant
- Generations of auditors before you have faced the same scenarios

David Elfanbaum
<table>
<thead>
<tr>
<th>Statement</th>
<th>Strongly agree</th>
<th>Somewhat agree</th>
<th>Disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit committee chair meets periodically with the CAE without the presence of management</td>
<td>68%</td>
<td>17%</td>
<td>15%</td>
</tr>
<tr>
<td>Audit committee addresses with the CAE issues related to internal audit independence and objectivity</td>
<td>62%</td>
<td>28%</td>
<td>11%</td>
</tr>
<tr>
<td>Audit committee has clear understanding of strengths and weaknesses of the organization’s internal control and risk management</td>
<td>53%</td>
<td>40%</td>
<td>7%</td>
</tr>
<tr>
<td>Audit committee acts forcefully to support the role and views of internal audit if there is a dispute between the CAE and management</td>
<td>52%</td>
<td>38%</td>
<td>10%</td>
</tr>
<tr>
<td>Audit committee reviews and approves resources of the internal audit activity</td>
<td>48%</td>
<td>29%</td>
<td>24%</td>
</tr>
<tr>
<td>Audit committee regularly communicates with the CAE about performance and improvement of internal audit</td>
<td>38%</td>
<td>43%</td>
<td>19%</td>
</tr>
</tbody>
</table>
The Modern Internal Auditor
Our Reputation is Not Always the Best

Trusted Advisor
“There are risks and costs to a program of action. But they are far less than the long-range risks and costs of comfortable inaction.”

- John F. Kennedy
Looking back, we should have looked ahead

Looking ahead, don’t look back with any regrets
Thank You