Internal Auditor Liability
Why You Should Pay Close Attention To
The Current Litigation Involving
Internal Auditors

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Test Your Knowledge
A major section of Sarbanes-Oxley relates to the external and internal audit function. Among other things, the law requires that the audit committee of a board of directors of a public corporation shall:

a. Be comprised entirely of the guys in your favorite foursome at the club.
b. Not be related by more than one marriage, divorce or adulterous affair.
c. Maintain confidentiality about each others’ stays in Hazelden, Betty Ford, the Grand Lodge of Free and Independent Masons, and Skull and Bones.
d. Approve the hiring and compensation of auditors, directly supervise the activities of the internal audit function, provide procedures to receive confidential, anonymous submission by employees about questionable accounting or auditing matters, and pre-approve any non-audit services provided by the external auditor.
Internal Auditors in Crosshairs

Internal Audit and AIG

• In late 2007 an internal auditor questioned Joseph Cassano, the head of AIG’s CDS business in London, about the request from counterparties to the Financial Products Division for billions of dollars of collateral related to derivatives it had sold.

• During the last week of 2007, Cassano reportedly told the AIG internal auditor, who questioned why he was being excluded from meetings discussing the valuations placed on these CDS assets, “...you would pollute the process....”

• The internal auditor resigned on October 1, 2007. AIG’s Chief Audit Executive asked him why he was resigning. The CAE indicated he would his concerns to AIG’s Audit Committee. If this happened, it would indicate key AIG executives were aware of the internal auditor’s concerns early on.
Internal Auditors in Crosshairs

Internal Audit and Société Générale

• Société Générale 2006 Annual Report devoted several pages to risk management and controls including descriptions of an elaborate internal control organizational structure and its interaction with the Audit Committee.

• Société Générale had the benefit of both Ernst & Young and Deloitte to assist them in making sure risk management was in order and functioning.

• There’s an entire chapter in the Annual Report devoted to Risk Management covering all the risks they face and the myriad of policies, procedures, organizations and systems they, theoretically, have in place to manage them.

• How, then, was rogue trader Jerome Kerviel able to bypass, ignore, and flaunt this process to lose billions trading existent and non-existent off-exchange products?
Navistar brought in a new CAE to clean up internal audit function after accounting scandals and delisting. He is now a Sox whistleblower:

“Regardless of their ethics, and particularly in a poor economy, CAE’s have careers to safeguard and families to feed. As a result of SOx, most CAE’s officially report to the Audit Committee. However, in most cases, there is still a “not so dotted” line to the CFO who, more likely than not, is responsible for the CAE’s annual performance appraisal. If a CAE loses his/her job as the result of whistle blowing or otherwise pushing management to to what’s right, what opportunities are there?”
JPMorgan Chase “Whale” Trade

• The Senate Subcommittee investigation report cites deficiencies at JPMorgan in five major activities that led to the “Whale” losses including internal audit.
  – Management focus and action on reports that cited weaknesses and other serious issues to address.
• PwC, should be receiving copies of all internal audit reports and reviewing them for issues and concerns, especially ones that are not being addressed on a timely basis by management.
JPMorgan Chase “Whale” Trade

• A 2010 internal audit report highlighted issues with the CIO’s VCG risk and valuation models “which have not been subject to review by the Model Risk Group…and the absence of a formally applied price sourcing hierarchy, insufficient consideration of potentially applicable fair value adjustments, the lack of formally documented/consistently applied price testing thresholds.”
  – Subcommittee exhibits show only the PwC Audit Team Assistant was copied on distribution of 2010.
  – Due date for fixing exceptions was July 2012.
• OCC Consent order also said” internal audit processes and procedures related to the credit derivatives trading conducted by the CIO were not effective”.
  – CAE and first deputy of CIO replaced.
Colonial Bank

• In November 2012, the FDIC filed suit against Colonial Bank auditor PwC and internal audit co-source vendor Crowe Horwath, for professional malpractice and breach of contract.
• This is the first FDIC suit against an auditor for financial crisis era bank frauds or failures.
• FDIC claims PwC and Crowe Horwath failed to detect that two Colonial employees helped the notorious (and defunct) mortgage lender Taylor Bean poke hundred-million-dollar holes in Colonial’s balance sheet.
Colonial Bank

• The FDIC complaint has more details about what PwC didn’t do in its audits than a private securities litigation complaint for the same bank.
• Several allegations made in the FDIC complaint are supported by knowledge of the audit choices PwC made, or did not make, including those related to its reliance or lack of reliance on the work of the internal audit co-source firm Crowe Horwath, that most likely came from
  – The workpapers
  – PCAOB inspection findings pertaining to Colonial
  – The reluctant but compelling cooperation of PwC
• Crowe Horwath LLP acted under a consulting contract as Colonial Bank’s internal audit department.
• The FDIC’s allegations against Crowe are unusual.
• PwC’s work papers give the FDIC a peek into PwC’s opinion of the quality of Crowe’s work.
• The FDIC must believe also PwC did not do enough to compensate for any failings or verify the assertions about internal controls Crowe made on behalf of Colonial management.
FDIC is holding to two standards: AICPA standards for consulting work and the IIA standards.

- Should an outsourcing vendor be held to a higher standard than an internally staffed IA function since they are selling that expertise?

AICPA standards for consulting are stringent but usually cited in litigation over systems and technology assignments not internal audit co-sourcing.

- Do not carry force of law that SOx and PCAOB standards do.

What about internal audit co-sourcing practices that are part of the assurance practice at public accounting firms?

- Are they performing assurance or consulting services?

Sometimes internal audit practice staff at public accounting firms support Sox 404 work for an external audit team.

- What professional standards are they held to?
Colonial Bank

• The FDIC also says Crowe should have followed professional standards promulgated by the Institute of Internal Auditors.
• Would an internal audit function staffed by Colonial employees instead of an outside vendor have been sued under the same circumstances?
• Why isn’t the FDIC naming the Internal Audit Liaison Manager as a defendant too?
• The FDIC is asserting gross negligence by Crowe.
• There was concealment and collusion to perpetrate a fraud within the bank and from outside forces.
  – Internal controls are not very effective when executives collude and conceal information. This limitation is mentioned in the COSO internal control model.
  – Does that let Crowe off the hook?
AgFeed

• AgFeed was a Chinese company with a US listing via a reverse merger. It filed for bankruptcy in July of 2013 as a result of fraud.
• Recently the company and six of its executives were charged by the SEC with various fraud-related allegations.
• Protiviti provided support to AgFeed’s executives and its board of directors from at least 2008, in the areas of Sarbanes-Oxley support to management, support for an SEC investigation, and internal audit co-sourcing.
AgFeed

• When Protiviti agreed to be the AgFeed outsourced internal audit function in 1/2013, it had not yet been paid for its work on the 2011 Sarbanes-Oxley management assessment support or its work related to the SEC investigation and subpoena.

• Protiviti is an AgFeed creditor in bankruptcy, owed $193,416.87 by the AgFeed estate according to its filing.
The Protiviti master services agreement does not commit the firm to performing any of its consulting work under any recognized industry standards.

Protiviti’s consulting work would not be governed by the AICPA standards for consulting since it is not a public accounting firm.

Protiviti did not expand on this no-standards statement as internal audit co-sourcer, such as agreeing to work under IIA standards.

Protiviti has not yet been named in any lawsuits as a defendant.
SCOTUS
Whistleblower Decision

The Supreme Court ruled March 4 that private contractors are entitled to federal whistle-blower protection when they expose fraud at public companies.

"Congress ... understood that outside professionals are responsible for reporting fraud by the public companies they serve," Justice Ruth Bader Ginsburg said.

"Congress further learned that fear of retaliation was the primary reason why the employees of Enron's contractors kept quiet about the fraudulent practices they witnessed."
SCOTUS
Whistleblower Decision

• The Supreme Court decision says Congress enacted the whistleblower provisions of SOX out of concern that Enron had a “corporate code of silence” that “discourage[d] employees from reporting fraudulent behavior[.]” The lack of a whistleblower protection was “a significant deficiency[.]”

• **Will protection against retaliation encourage a passive person to do the right thing?** (Or will it take a Dodd-Frank bounty?)

• **How often does an auditor or consultant or lawyer actively facilitate fraud or help cover-up it up only because they are fearful or losing their job or other retaliation?**
How To Protect Yourself

• Choose your employer wisely.
  – A troubled company can be very interesting but very risky. Do your homework. Know what you’re getting into.
  – CAEs: Demand employment contracts and/or no-fault divorces.
• Choose your allies within carefully.
• Document everything!
• Educate Audit Committee members but don’t coddle them.
• Be part of the “privilege” inner circle. If not, you’ll be left out and not protected.
• Align with outside attorneys on internal investigations. You may need their help for the whistleblower suit.
• Don’t be a hero unless you’re so rich or so poor. Book deals and speaking fees are not worth it.
• Don’t be a scapegoat. See trouble? Get the hell out of Dodge!
Why Are Auditors Rarely Whistleblowers?

- Judgmental, rigid, black and white morality that squashes skepticism. Mind made up.
- Followers not leaders
- Reluctance to be an “outlier” or ostracized for unpopular or uncomfortable views. “Pleasers”
- Lack of diversity breeds in-group bias.
- Lack of focus in undergraduate curriculum on independent, critical thinking skills.
- Taught form over content (What did we do last year? If it’s not on the form or checklist we can’t or shouldn’t do it. Must stay within time and money budget.)
- Recruiting focuses on “fit”, trainability, willingness to conform for future rewards, and respect for authority and precedent.
- Discomfort with change and uncertainty that arises from questioning values and tenets of profession, firm, colleagues.
- Career and financial security is a priority.
McKenna Partners LLC provides specialized consulting to attorneys in cases involving the audit firms, in particular when they have a global reach. McKenna’s knowledge of the internal operations of the firms especially on independence, legal and regulatory compliance, risk and quality management, internal systems/processes and global network legal and regulatory issues is unprecedented and rarely available outside the firms in an independent and objective form.
Internal Auditor Liability

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- Martin W. Terpstra is a Partner in the Forensic and Valuation Services Group of Plante Moran. He is a certified public accountant and a certified fraud examiner with over 38 years of experience as an auditor, consultant and fraud examiner covering many diverse industries.

- Marty is a frequent speaker for professional organizations and serves as an adjunct faculty member at Benedictine University, teaching courses in forensic accounting and auditing. He has developed risk management programs for accounting firms, which he presents nationally to such firms and professional organizations. He has also developed training programs for insurance claims specialists and fraud detection and prevention programs.
Law & Regulations

• Sarbanes - Oxley Act of 2002
• New York Stock Exchange (NYSE) Listing Standards
• NASDAQ Listing Standards
• FDIC Statements of Policy
Laws & Regulations

Sarbanes - Oxley Act of 2002

- Title II, §201(a) prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit outsourcing services to the company.
Laws & Regulations

New York Stock Exchange Listing Standards

• §303A.07 – “Each listed company must have an internal audit function.”

• “Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company’s risk management processes and system of internal control.”

• “A listed company may choose to outsource this function to a third-party service provider other than its independent auditor.”
Laws & Regulations

New York Stock Exchange Listing Standards

• On August 22, 2013, the SEC approved a rule change to §303A.00 that permits certain categories of newly-listed companies to avail themselves of a transition period to comply with the internal audit function. However, all listed companies must have an internal audit function in place no later than the first anniversary of the company’s listing date.

• Such newly-listed companies include initial public offerings, carve-outs, and spin-offs.
Laws & Regulations

NASDAQ Listing Standards

• In early 2013, NASDAQ filed a proposed rule change with the SEC requiring listed companies to establish and maintain an internal audit function.

• NASDAQ said although companies may outsource this function to a third-party service provider other than their internal auditor, the audit committees would have sole responsibility to oversee the internal audit function.

• In May 2013, NASDAQ withdrew its proposal.
Laws & Regulations

FDIC Statements of Policy

- An important element in assessing the effectiveness of the internal control system is an internal audit function.
- Pursuant to §39 of the Federal Deposit Insurance Act, the agencies have adopted Interagency Guidelines Establishing Standards for Safety and Soundness that apply to insured depository institutions.
- Under these guidelines and policies, each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities.
Laws & Regulations

FDIC Statements of Policy

• The board of directors and senior management are responsible for having an effective system of internal control and an effective internal audit function in place at their institution.

• Directors should consider whether their institution’s internal audit activities are conducted in accordance with professional standards, such as the IIA Standards for the Professional Practice of Internal Auditing.

• The audit committee should oversee the internal audit function and evaluate its performance.

• An outsourcing vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee and, if applicable, will comply with AICPA, SEC, PCAOB, or regulatory independence guidance.
Certifications

- **Institute of Internal Auditors (IIA)**
  - Certified Internal Auditor (CIA)
  - Certified Government Auditing Professional (CGAP)
  - Certified Financial Services Auditor (CFSA)
  - Certified in Control Self-Assessment (CCSA)
  - Certified in Risk Management Assurance (CRMA)

- **American Institute of Certified Public Accountants (AICPA)**
  - Certified Public Accountant (CPA)
    - Accredited in Business Valuation (ABV)
    - Certified in Financial Forensics (CFF)
    - Certified Information Technology Professional (CITP)
    - Certified Global Management Accountant (CGMA)

- **Association of Certified Fraud Examiners (ACFE)**
  - Certified Fraud Examiner

- **Information Systems Audit and Control Association (ISACA)**
  - Certified Internal Systems Auditor (CISA)
  - Certified Information Security Manager (CISM)
  - Certified in the Governance of Enterprise IT (CGEIT)
  - Certified in Risk and Information Systems Control (CRISC)
Professional Standards

• Institute of Internal Auditors (IIA)
• American Institute of Certified Public Accountants (AICPA)
• Public Companies Accounting Oversight Board (PCAOB)
• Government Auditing Standards
• Association of Certified Fraud Examiners (ACFE)
• Information Systems Audit and Control Association (ISACA)
Institute of Internal Auditors

Mandatory Guidance

• Definition of Internal Auditing
• Code of Ethics
• International Standards for the Professional Practice of Internal Auditing
  o Attribute Standards
  o Performance Standards
AICPA

- Code of Professional Conduct (ET)
  - Rule 101 – Independence
  - Rule 201 – General Standards
  - Rule 202 – Compliance with Standards
- Statement on Consulting Standards (CS)
- Statements on Auditing Standards (AU-C)
  - AU-C 240 – Consideration of Fraud in a Financial Statement Audit
  - AU-C 260 – The Auditor’s Communications With Those Charged With Governance
  - AU-C 610 – The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements
• Professional Standards
  o Rule 3100 – Compliance with Auditing and Related Professional Practice Standards
  o Rule 3200T – Interim Auditing Standards
  o Rule 3500T – Interim Ethics Standards
  o Rule 3520 – Auditor Independence
  o Rule 3600 T – Interim Independence Standards
• Auditing Standards
  o AS 5 – An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements
  o AS 10 – Supervision of the Audit Engagement
  o AS 12 – Identifying and Assessing Risks of Material Misstatement
  o AS 15 – Audit Evidence
• Interim Auditing Standards
  o AU 322 – The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements (as revised)
Government Auditing Standards

General Accounting Office – Yellow Book

• Chapter 1 – Government Auditing: Foundation and Ethical Principles
• Chapter 2 – Standards for Use and Application of GAGAS
  o 2.21 – Relationship between GAGAS and Other Professional Standards – IIA
• Chapter 3 – General Standards
  o 3.31 – Internal Auditor Independence – IIA
• Chapter 4 – Standards for Financial Audits
• Chapter 5 – Standards for Attestation Engagements
• Chapter 6 – Field Work Standards for Performance Audits
• Chapter 7 – Reporting Standards for Performance Audits
• Appendix II – Conceptual Framework for Independence
ACFE

- ACFE Code of Professional Ethics
- CFE Code of Professional Standards
- *Fraud Examiners Manual*
  - Internal Auditors’ Fraud-Related Responsibilities – refers to IIA Standards and Professional Practices Framework
ISACA

- Code of Professional Ethics
- IS Audit and Assurance Standards
- ITAF – Information Technology Assurance Framework
References

References:
• IIA website – theiia.org
• AICPA website – aicpa.org
• PCAOB website – pcaobus.org
• GAO website – gao.gov
• ACFE website – acfe.com
• ISACA website – isaca.org
• SEC website – sec.gov
• NYSE website – nyse.com
• NASDAQ website – nasdaq.com
• FDIC website – fdic.gov

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