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Where are the Auditors?

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I usually write about the business of the Big Four auditors—Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers. In seven years I've never run out of stories to tell. In fact, there are so many I now have to send some to big media reporters just to make sure they are covered. I routinely tip other journalists and am quoted by others in the interest of making sure the stories are written and that they are written well and completely.

Since I am here at the invitation of an IIA chapter, I'm going to talk about some of the most recent scandals and frauds from the perspective of internal controls and the role and responsibility of internal audit. I bet you didn't know that internal audit played a significant role in some of the major stories in the past few years?

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 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 is a French bank and so it has the benefit of two external auditors. Ernst & Young and Deloitte were responsible for reviewing the bank's risk management function at that time, making sure it was in order and functioning as a key entity level internal control over financial reporting.

There's an entire chapter in the Société Générale 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

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? "

MF Global and Jon Corzine, rogue trader

Felix Salmon, Reuters columnist, wrote in December 12, 2011about a piece by the New York Times Dealbook section.

MF Global was the futures commission merchant/broker dealer that went bankrupt on October 31, 2011. It was led, most recently, by former senator and governor of New Jersey Jon Corzine, also a Goldman Sachs veteran. The auditor was PwC. The sexy part was that when it went under, 1.6 billion of customer trading funds were missing.

Felix says the Dealbook piece removes any doubt about what went wrong at MF Global. The firm's sudden death was entirely the fault of Jon Corzine. Some people characterized Corzine at the time as a "rogue trader" just on the basis of the size and riskiness of MF Global's $6.3 billion bet on European sovereign debt. But Felix says that Corzine demonstrated virtually all of the pathologies of the rogue trader more generally.

Lots of financial firms make big bets and blow up. Corzine gave the details prepared testimony before the House Agricultural Committee. His big sovereign-debt bet didn't actually lose money at all.

But MF Global died all the same, because the bet was so large and risky that it caused a fatal cascade of debt rating downgrades and margin calls from trading counterparties.

The risk of such a fatal cascade should always be front of mind at any broker-dealer. All such firms are supposed to have mechanisms in place to prevent any single bet getting big enough to imperil the company as a whole. Those risk management policies, in particular for safeguarding customer funds, are supposed to be reviewed by the external auditor at broker-dealers. PwC gave MF Global a clean audit opinion until the end.

What's the difference between a rogue trader and a trader who simply has big losses? Rogues…

- Develop an ability to circumvent risk-management controls;
- Aspire to be recognized as a star trader making huge amounts of money for the firm;
- Tend to arrive earlier and leave later than anybody else, as they jealously guard their trades;
- Panic when losses start appearing, and then doing illegal things to get back in the black or to hide their losses.

Corzine more ability to get around risk-management controls than most rogue traders, because he was the CEO and Chairman of MF Global. As a result, his big sovereign bet was, relative to the size of the company that made it, by far the largest rogue trade of all time.

The way he circumvented existing controls was brazen:

Soon after joining MF Global, Mr. Corzine torpedoed an effort to build a new risk system, a much-needed overhaul…

In August, some directors questioned him, asking him to reduce the size of the sovereign debt trade position. Mr. Corzine reassured then threatened them:

"If you want a smaller or different position, maybe you don't have the right guy here," he told them.

As CEO he could and did overrule or ignore any concerns about his big trade:

"One senior trader said that each time he addressed his concerns, the chief executive would nod with understanding but do nothing,"

Only the board had the ability to rein Corzine in but they were intimidated.

A CEO should be paranoid about all risks; a rogue trader wants to hide them. Corzine made sure the sovereign debt trade was structured in a way that minimized its perceived riskiness:

The Repo-to-maturity treatment allowed MF Global to classify the purchase of the sovereign bonds as a sale, keeping the full extent of the exposure off the balance sheet.

Corzine was obsessed with trading. He compulsively traded for the firm on his BlackBerry during meetings, sometimes dashing out to check on the markets. And unusually for a chief executive, he was a core member of the group that traded using the firm's money. His profits and losses appeared on a separate line in reports with his initials.

But at MF Global, where he was charged with turning around the entire company, the picture of the CEO trading on his Blackberry during meetings is, frankly, bonkers.

Corzine is not in jail and continues to fight civil lawsuits against him by the CFTC and shareholders.

JPMorgan Chase "Whale" Trade

A Senate Subcommittee investigation report cites deficiencies at JPMorgan in five major activities that led to the "Whale" losses including internal audit. The report said there was poor management focus and action on internal audit reports that cited weaknesses and other serious issues to address.

PwC, JPM's auditor, should have been receiving copies of all internal audit reports and reviewing them for issues and concerns, especially ones that were not being addressed on a timely basis by management.

A 2010 internal audit report highlighted issues with the CIO's risk and valuation models and said that they had "not been subject to review by the Model Risk Group…" It cited issues with the fact that there was no "formally applied price sourcing hierarchy, insufficient consideration of potentially applicable fair value adjustments, the lack of formally documented/consistently applied price testing thresholds."

Senate Subcommittee exhibits show only the PwC Audit Team Assistant was copied on the distribution of the 2010 report. The due date for fixing exceptions was July 2012. Questions about the trade surfaced on the bank's 1Q earnings call April 13, 2012.

The bank was subject to an OCC Consent order that said "internal audit processes and procedures related to the credit derivatives trading conducted by the CIO were not effective". CAE and first deputy of the Chief Investment Office were replaced and the CFO went back to Investment Banking. Several other changes n the risk management function and CIO office have occurred since.

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 related ot the failure of Colonial Bank. This was the first FDIC suit against an auditor for financial crisis era bank frauds or failures.

The 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. 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 audit workpapers.

The FDIC would also presumably have access, as a regulator to any PCAOB inspection findings pertaining to PwC's audit of Colonial Bank.

The FDIC's allegations against Crowe are unusual. Crowe Horwath LLP acted under a consulting contract as Colonial Bank's internal audit department. 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 that PwC did not do enough to compensate for any failings or verify the assertions about internal controls Crowe made on behalf of Colonial management.

The FDIC is holding Crowe, as a third-party internal audit services provider, 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. They 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. Which professional standards are they held to?

The FDIC is asserting gross negligence by Crowe. The FDIC says in its lawsuit that 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?

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 he 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.

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 it 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

How many of you are internal auditors in industry? In a public accounting firm? In a third-party service provider that's not a pubic accounting firm like Protiviti or Resources Global?

The Supreme Court ruled March 4 that private contractors are entitled to federal whistle-blower protection against retaliation 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."

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?

Why Are Auditors Rarely Whistleblowers?

- Career and financial security is a priority.
- Judgmental, rigid, black and white morality that squashes skepticism. Mind made up.
- Discomfort with change and uncertainty that arises from questioning values and tenets of profession, firm, colleagues.
- Follower not leader
- Reluctance to be an "outlier" or ostracized for unpopular or uncomfortable views.
- "Pleasers"
- Recruiting focuses on "fit", trainability, willingness to conform for future rewards, and respect for authority and precedent.
- Lack of diversity in work groups 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.)

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! (Does that still work? See AgFeed Audit Committee Chairman and Big Four staff sanctioned for backdating workpapers.)

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