

Separating Fact from Fantasy

What Auditors Really Need to Know & Do About Risk in 2012



Dallas IIA Chapter – December 1, 2011

Courtenay M. Thompson Jr.

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Belief → Action → Results

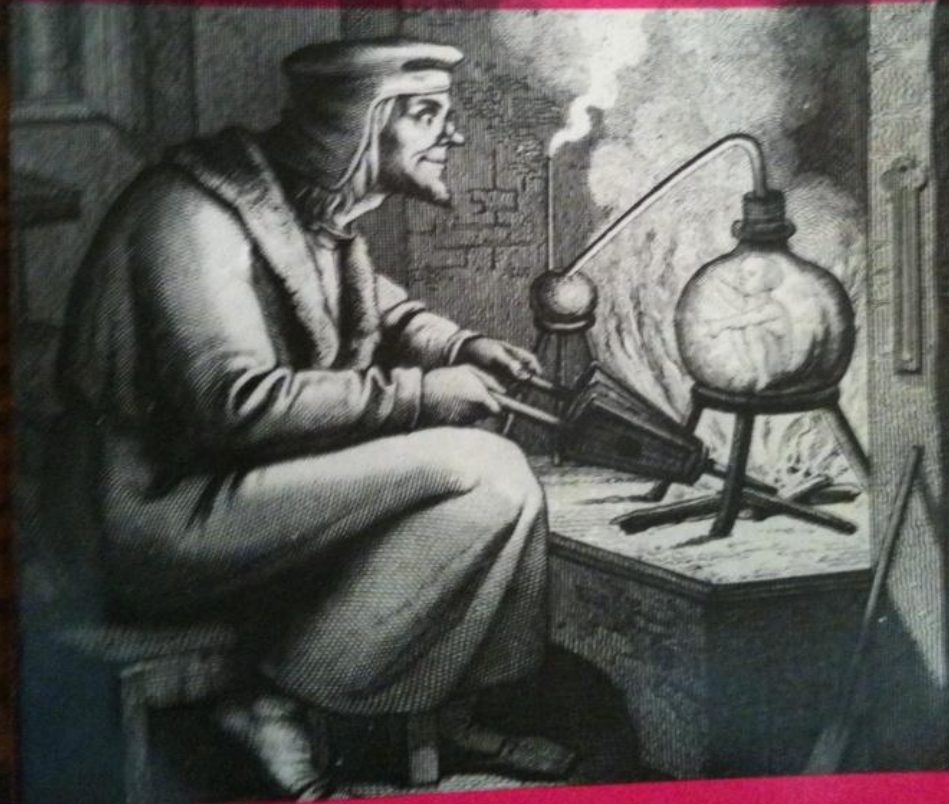
A Passion for Internal Auditing

Foreword by Bernard M. Baruch

Extraordinary Popular Delusions

and the Madness of Crowds

BY CHARLES MACKAY, LL. D.



MacKay Explored Human Nature

- Tulipomania
- South Sea Bubble
- The Mississippi Scheme

A
SHORT
HISTORY OF
FINANCIAL
EUPHORIA



JOHN KENNETH
GALBRAITH

John Kenneth Galbraith in
*A Short History of
Financial Euphoria*
tells us that there has long
been speculative euphoria.

It is:

- Predictable
- Recognizable
- Avoidable.

“It’s quite amazing... It’s like having a near-death car experience, and you get back in the car and you drive just as wildly as before.”

**John Reed,
former CO-CEO
of Citigroup**

Quoted in Fortune Magazine, October 2010, describing behavior of bankers...

What's Going On? Increasing complexity because of :

- 1. Technology**
- 2. Global sources & markets**
- 3. Increased visibility around the world**
- 4. Environmental concerns**
- 5. Leaders commitment to personal wealth & power**
- 6. Erosion of character**
- 7. Increased reliance on 3rd parties**

Increasing scandals:

1970's

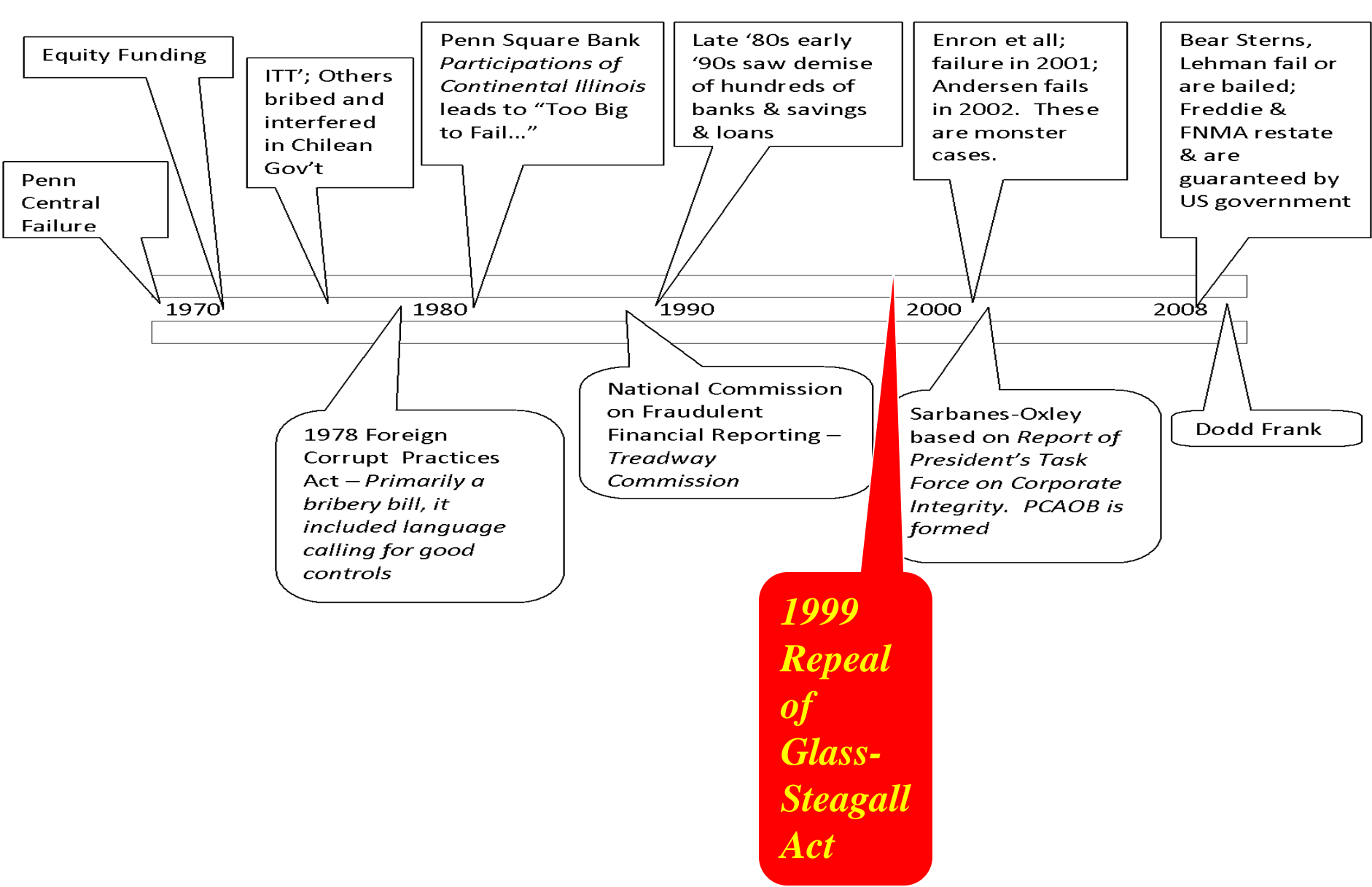
1980's

1990's

2000's

2010's?

We seem unable or unwilling to address causes.



CFO

FOR FINANCIAL OFFICERS

APRIL 1987
VOL. 3
NO. 4



FRAUD REPORT

**PREADSHEETS ON
MANAGING CASH FLOW**

**DIRECTORS AND OFFICERS
LIABILITY INSURANCE**

**BUYER'S GUIDE TO
REPORT-WRITING SOFTWARE**

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ATM06255RAMIB DN CF JUN87
COURTENAY THOMPSON
COURTENAY THOMPSON ASSOC
2007 ANGLEW RD STE 750
DALLAS TX 75231

James C. Treadway, Jr.,
Chairman of the Commission on
Fraudulent Financial Reporting

*Despite all these
efforts we continue
to have scandals...*










Why?

There has been a failure of

COMPETENCE

INTEGRITY

COURAGE

Failure of 	Competence	Integrity	Courage
CEO			
CFO			
CPAs			

FFR - What's Going On?

Solutions have:

1. Seemed to provide the **illusion** of addressing FFR
2. Provided regulation
3. Created revenue for consultants
4. Done little to reduce risk of **FFR**

*Effective Executives
have always understood
their risks!*

NEW YORK TIMES BESTSELLER

THE
BLACK SWAN



The Impact of the
HIGHLY IMPROBABLE

"The most prophetic voice of all."

—GQ

Nassim Nicholas Taleb

“During my eighty-seven years I have witnessed a whole succession of technological revolutions. But none of them has done away with the need for character in the individual or the ability to think.”

Bernard Baruch

**Technology can lull
management into believing
all is well when it is not.**

Is there fraud that is facilitated by technology?

Without computers...

Could we have had derivatives?

Could we have program trading?

“Some contracts are just too complicated and complex to be understood or audited.”

A quote from an audit manager.

Overcharges for Air Travel

Class action lawsuits

Settled by 3 firms for over
\$100 million

The Federal Government's
settlement was even more...

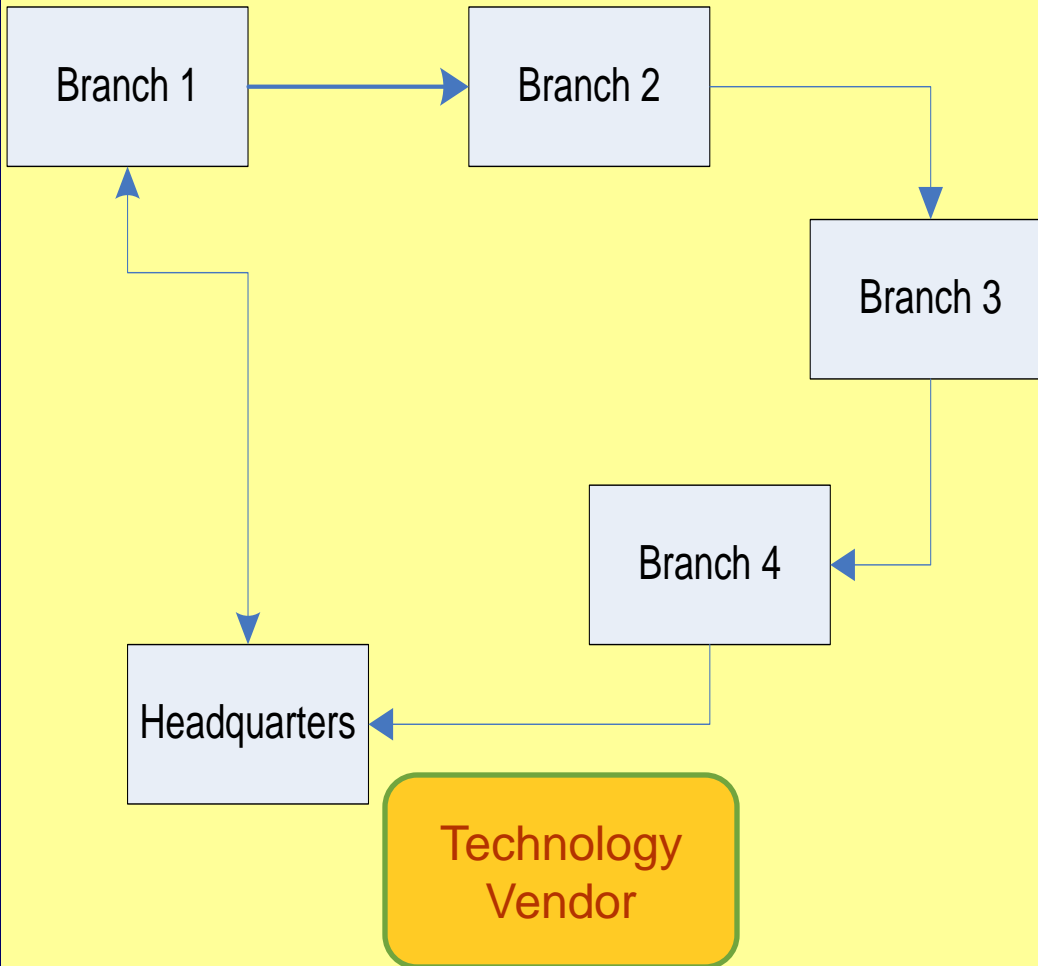
The most bothersome aspect...

*Some seem unable to
tell right from wrong.*

Marin County Allegations

- 1. Overstated capabilities & experience*
- 2. Billed for work not done*
- 3. Billed for substandard work*
- 4. Corrupted an approver*
 - To approve deficient work*
 - To approve more contracts*
- 5. Tried to silence dissent*

From Federal Complaint



A PC vendor worked on the computer network, traveling from branch to branch. The contract allowed billing for travel time and mileage. He made circle trips.

What do you think he billed for?

The local branch manager approved the invoice.

What do you think he thought he was approving?

Accounts payable paid the approved invoices.

What do you think they believed the approvals meant?

Let's look at the math...

“Our goal is 15% net income growth annually...”

In 1759 a cabinet maker built a beautiful secretary (desk) for which he was paid the equivalent of \$300. In 1999 the piece sold at auction for \$7,500,000!

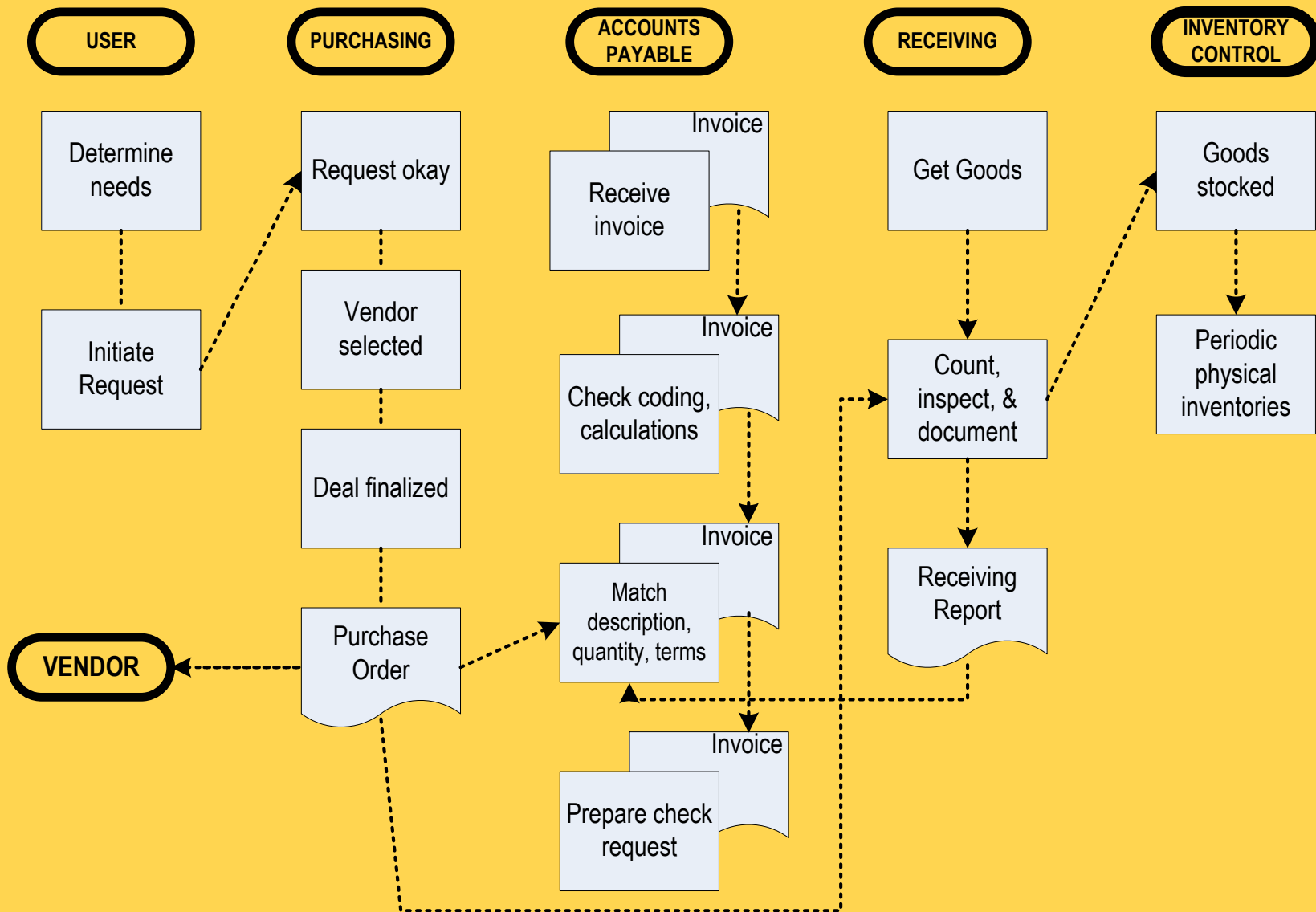
As happy as the owners were, would they have been better off getting 5% on their \$300 investment all those years?

Growth of \$300 compounded for 240 years...

\$361,456	3%
\$3,673,861	4%
\$36,521,872	5%
\$355,245,772	6%
\$3,382,422,847	7%
\$31,537,159,284	8%
\$288,058,543,512	9%
\$2,578,491,432,321	10%
\$22,627,478,635,729	11%
\$194,736,201,995,120	12%
\$1,644,173,676,288,230	13%
\$13,623,402,109,194,400	14%
\$110,816,119,854,613,000	15%

Are 15% growth goals realistic for sizeable organizations?

How long before a company is bigger than the entire economy?



Man is most credulous when happy.

from an early editor of **The Economist**

**We are most happy when
people tell us what we want to
hear!**

**We may be so happy we will
ignore all evidence that there
might be problems!**

**Success encourages
blindness!**

Unrealistic expectations have a role!

- Expectations about growth
- Faster is better...
- We can do more with less without sacrificing anything.
- *We will work harder and smarter.*
- Smart and well-educated people will make good decisions.
- Underestimating the time required to *think things through.*
- *People will act as if they are valued, no matter what!*

The Human Element

- **Willful blindness – *a factor in all major cases!***
- **Carelessness – *these are just technical matters!***
- **Making decisions for the wrong reasons**
- **Decisions are contaminated**
- **Emotions and ego play an exaggerated role**
- **Poor problem solving or decision making methods**

“Business decisions, as many of our colleagues and your own experience can attest, are frequently based on hope or fear, what others seem to be doing, what senior leaders have done and believe has worked in the past, and their dearly held ideologies – in short, on lots of things other than facts.”

Hard Facts, Dangerous Half-Truths & Total Nonsense
by Jeffrey Pfeffer and Robert I. Sutton

Suggestions for Auditors in 2012

- **Commit to KYY.**
- **Understand and influence executive attitudes about problem identification and response.**
- **Be sure that management understands the importance of knowing their risks.**
- **Commit to learning WGO in detail.**
- **Commit to understanding risks and exposures related to third party relationships.**
- **Commit to exploring new and evolving risks, particularly in technology.**
- **Audit where the action is!**

Courtenay M. Thompson Jr.

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