Conflict Resolution and Stakeholder Management for Internal Auditors

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Synopsis

The work of an internal auditor as a **third line role** in an organisation, may inevitably invite conflict with various stakeholders, an issue which is well commiserated but supported with limited literature.

This talk aims to explore the sources of these conflicts through the lenses of **Agency Theory**, as well as promoting self-assessment against **Cognitive Biases**, in order to minimise unnecessary conflicts.

However, **resolutions** are necessary where conflict are unavoidable, to be guided by principles without compromising the integrity of the internal auditor.

Objectives

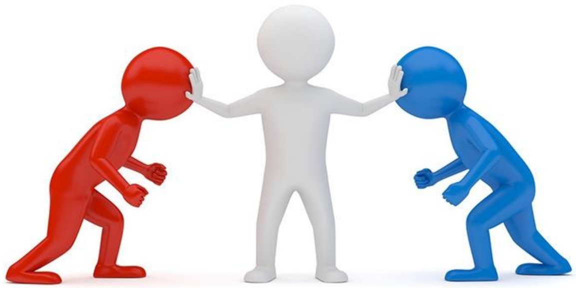
- To contextualise the issue of conflict in internal audit activities
- To understand the causes of conflict
- To be aware of cognitive biases that may compromise work quality and invite conflict.
- To be equipped with tools for conflict resolution.

Conflicts and internal auditing

Conflict arises whenever individuals have different

- values
- opinions
- needs
- interests

and are unable to find an agreeable settlement.



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Conflicts and internal auditing

4 classifications of organizational conflict:

1. Intrapersonal conflict – conflict within an individual where personal objectives are different from organizational objectives.
2. Interpersonal conflict – conflict between 2 or more individuals where triggers are personal differences, communication breakdown, role incompatibility, and environmental stress.

Conflicts and internal auditing

3. Intragroup conflict – conflict arising from an individuals's resistance to conform to group dynamics.

4. Intergroup conflict – conflict where two teams are involved in a deadlock, endangering the successful completion of a project due to differences in group dynamics.

Graphic source: drcaroladams.net

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Conflicts and internal auditing

Conflicts can be

- Functional
- Dysfunctional

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Conflicts and internal auditing

- **Conflict begins** when one side perceives that another side is frustrated or is about to frustrate.

- **Conflict arises** when there is disagreement where parties involved perceive a threat to something that each party cares about.

- **Conflict occurs** when there is an obligation to engage in an activity that does not meet his or her needs or interests

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Conflicts and internal auditing

What are some of the common examples of conflict in the work of an internal auditor?

Graphic source: shrm.org

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Agency Theory and the role of Internal Audit

- **Agency relationship** arises when principals (e.g. shareholders) engage others as their agent (e.g. management, employees) to perform a service on their behalf. (Jensen & Meckling, 1976)

- Purpose – promotes **effectiveness and efficiency -** but this requires **trust** in an agent to act in the principal's best interests.

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Agency Theory and the role of Internal Audit

- As a result of **information asymmetries** and **self interests**, principals may not fully trust their agents – this trust has an **agency cost – the audit function exist to monitor the activities of management and to attest to managements' performance**. (Colbert and Jahera, 1988)

Graphic source: td.org

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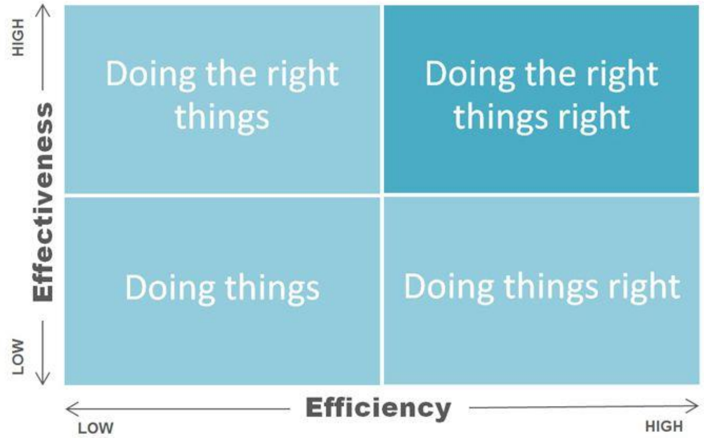
Agency Theory and the role of Internal Audit

- Internal audit's **assurance services to execute business activities according to management's conceptions**, and its **advisory services to enhance efficiency and effectiveness,** are interpreted within the firm's overarching goal of maximizing the rate of return on capital employed. (Mihret, 2014)



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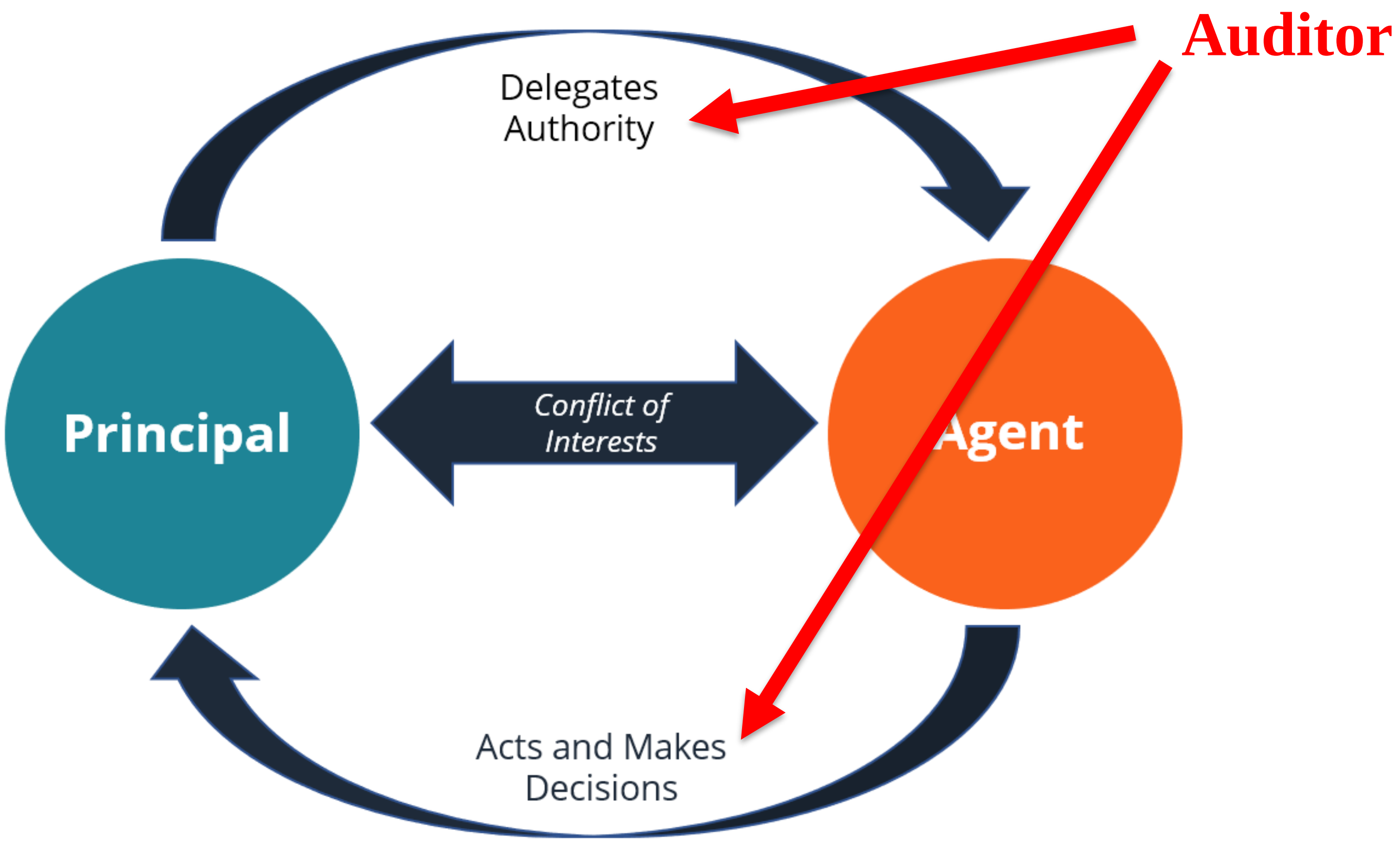
Agency Theory and the role of Internal Audit



Graphic source: Corporate Finance Institute

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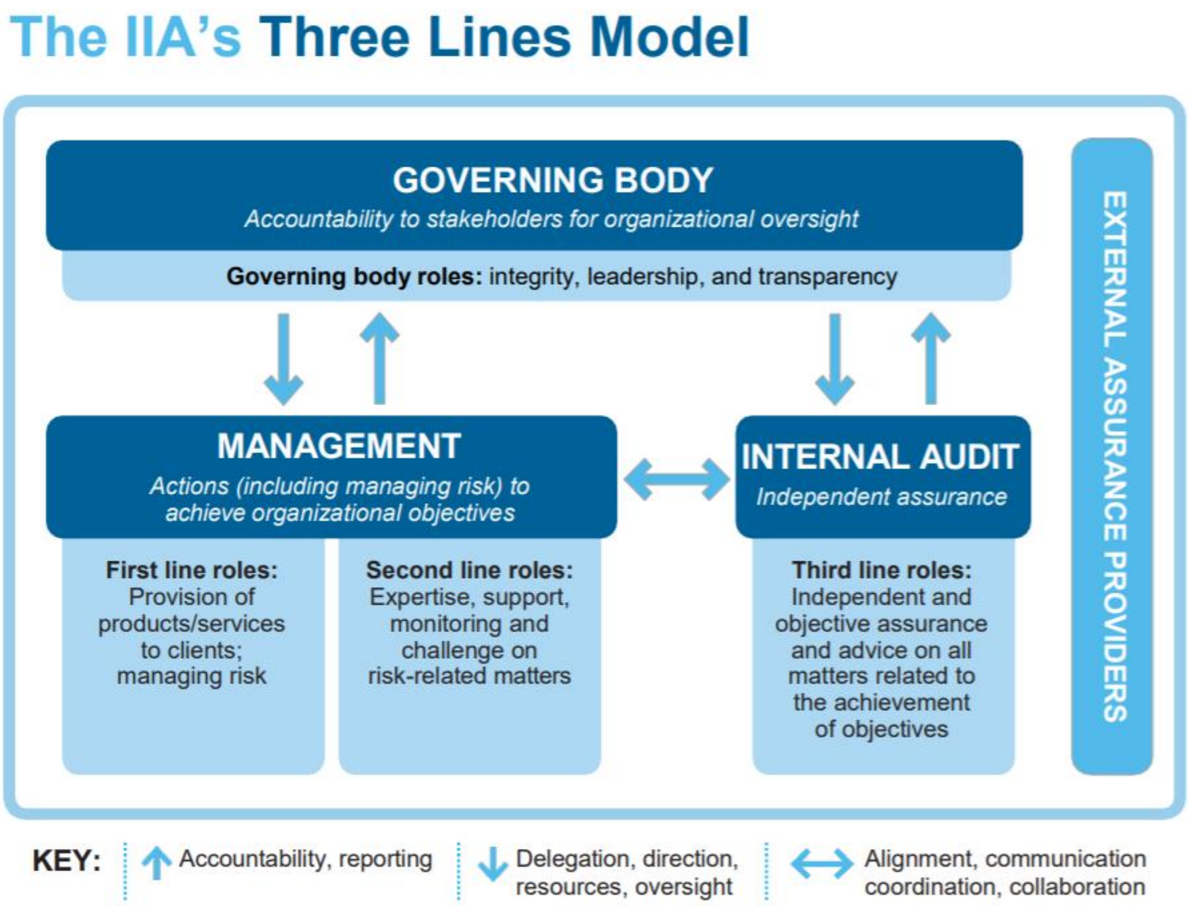
Three Lines Model



Source: The IIA's Three Line Model (July 2020)

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Three Lines Model

- Originally called the Three Lines of Defense in 2013, the model has gained popularity for organizing governance and risk management in organizations.

- The new Three Lines Model helps organizations better identify and structure interactions and responsibilities of key players toward **achieving more effective**
  - **Alignment**
  - **Collaboration**
  - **Accountability, and ultimately**
  - **Objectives**.

Source: The IIA's Three Line Model (July 2020)

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Three Lines Model

- The roles of the
  - first line – provision of products/services to clients at the front lines.
  - second line – provision of expertise, support, monitoring and challenge on risk-related matters – i.e. management
  - third line – provision of independent and objective assurance and advice on all matters related to the achievement of objectives – i.e. internal audit.

- **The model encourages both management and internal audit to coordinate with each other**.

Source: https://www.complianceweek.com/risk-management/iias-three-lines-of-defense-updated-to-stress-collaboration/29212.article

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Three Lines Model

- Although encouraged to collaborate with management, IA must still **remain independent** from the responsibilities of management in order to **maintain objectivity, authority, and credibility**.

Source: https://www.complianceweek.com/risk-management/iias-three-lines-of-defense-updated-to-stress-collaboration/29212.article

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Agency Theory and the role of Internal Audit

1100 – Independence and Objectivity

The internal audit activity must be independent, and internal auditors must be objective in performing their work.

Interpretation:

Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board.

An auditor who upholds their independence and objectivity would possibly put themselves in the line of conflict between principles and agents.

Source: International Standards for the Professional Practice of Internal Auditing

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Possible cognitive biases by internal auditors

Auditors are expected to exercise "**professional skepticism**" – a questioning and alert mind.

This should also extend to recognizing that there may be elements of **cognitive bias** by auditors themselves that has to be mitigated.

As scepticism is defined in auditing standards as a 'state of mind', it is necessary to look to the psychology literature for some of the answers. (ACCA, 2017)

Source: Banishing bias? Audit, objectivity and the value of professional skepticism, ACCA (March 2017)

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Possible cognitive biases by internal auditors

- Cognitive biases account for aspects of apparently **non-rational ways in which people reach decisions**.

- Cognitive biases can affect the auditor at various stages of the audit. They can also influence other stakeholders in ways that can both reduce audit quality and affect perceptions of audit quality

Source: Banishing bias? Audit, objectivity and the value of professional skepticism, ACCA.

Possible cognitive biases by internal auditors

In addition to cognitive biases, it is important to recognise the following structural constraints on the audit process.

1. There is **information asymmetry** between the client and the auditor. The client has much better knowledge about its business than the auditor does.
2. The auditor has **limited time** in which to form a view, and few mechanisms, in practice, to get more time.
3. The auditor has **limited resources** with which to form a view, and there are practical constraints on his or her ability to get more resources.

Source: Banishing bias? Audit, objectivity and the value of professional skepticism, ACCA.

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Possible cognitive biases by internal auditors

- The literature on cognitive biases is rooted in the work of Tversky and Kahneman (1975) on theory of the firm which sought to explain why some human judgements appear to be irrational or suboptimal.

Possible cognitive biases by internal auditors

The 12 most relevant cognitive biases in the audit process (ACCA,2017):

- hindsight bias
- outcome bias
- confirmation bias
- anchoring bias
- availability heuristic
- groupthink
- overconfidence
- recency
- conjunction bias
- selective perception
- stereotyping
- blind-spot bias.

Source: Banishing bias? Audit, objectivity and the value of professional skepticism. ACCA (March 2017).

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Possible cognitive biases by internal auditors

Cognitive Bias	Interpretation	Example
Confirmation bias	Auditors may seek to confirm their hypotheses and so may favour information that confirms rather than refutes their initial assessments.	Auditees may withhold or delay provision of information or documents if they perceive auditors to have this bias.
Overconfidence bias	Auditors may overestimate their abilities to form conclusions or make accurate recommendations.	Auditees may challenge the findings of auditors on the basis that the samples were not representative, or has underlying reasons.

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Possible cognitive biases by internal auditors

Cognitive Bias	Interpretation	Example
Conjunction bias	Auditors may think that certain specific circumstances or risks are more important or probable than general circumstances or risks.	Auditees may not agree with the risk impact and likelihood assigned by the auditor.
Available heuristic	Auditors may overestimate the importance of information that is made available without considering the sufficiency or completeness of information.	Auditees may provide information that could mislead the auditor into forming favourable conclusions to the detriment of principals.

Possible cognitive biases by internal auditors

Cognitive Bias	Interpretation	Example
Anchoring bias	Auditors may tend to use an initial piece of information as an ‘anchor’ against which subsequent information is judged.	Auditees may not agree with how the audit finding is presented, which may skew the perception of the principal.
Outcome bias	Auditors may judge the value of an action based on its outcome, rather than the value of the procedure i.e. report as many audit issues as possible.	Auditees may feel threatened over the volume of audit issues presented.

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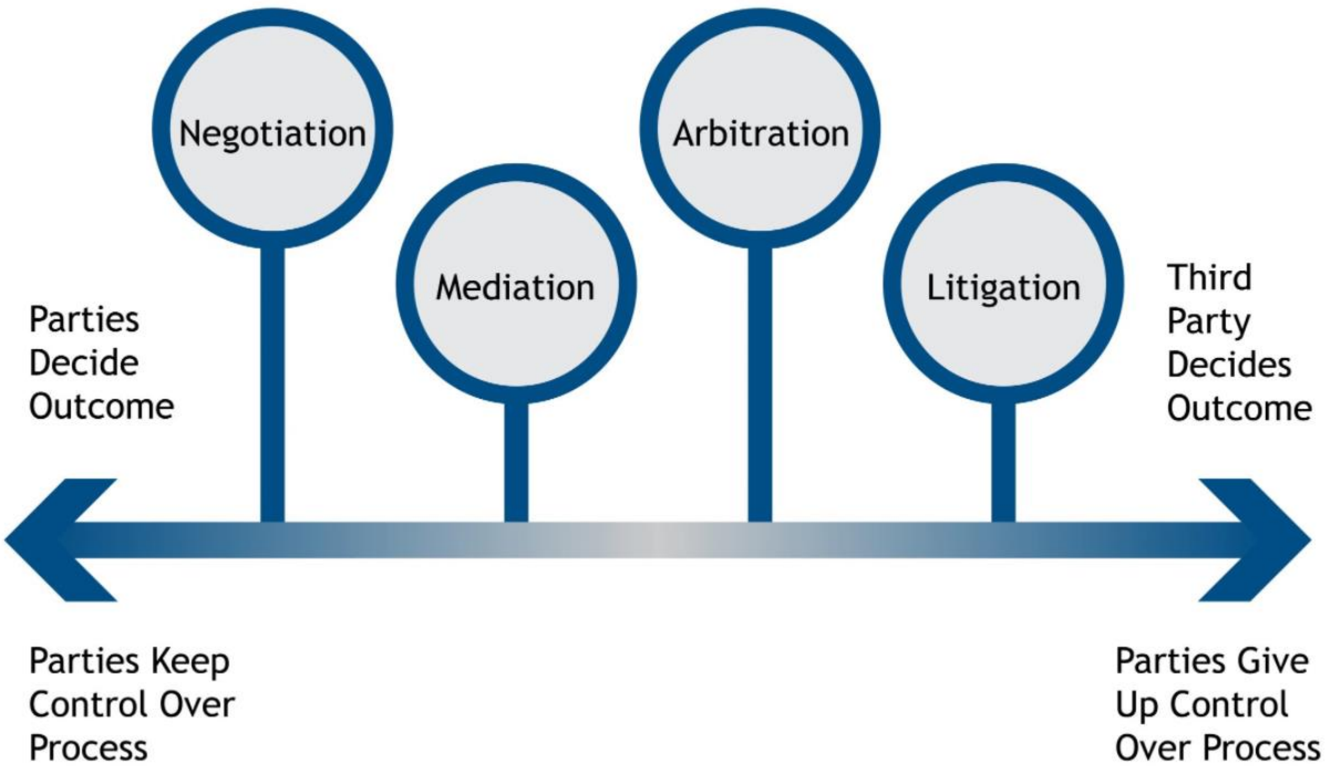
Conflict Resolution Model



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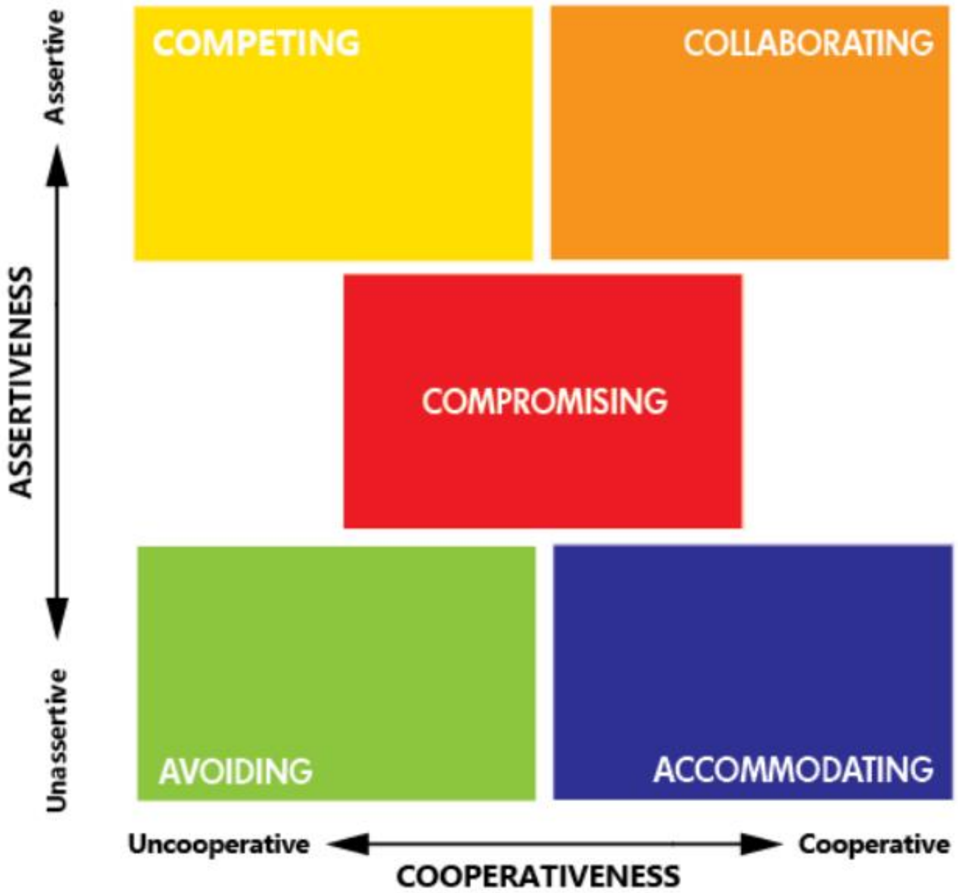
Conflict Resolution Model



Source: Thomas and Kilmann (1974)

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Conflict Resolution Model

Abridged action plan:

- Re-establish or revisit our objectives.
- Determine the objectives of the conflicting parties.
- Listen to the views of the conflicting parties.
- Focus on the issues rather than the personalities.
- Draw the conflicting parties into searching for solutions.
- Seek mediation.

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Conclusion

- Prevention of conflict is better than escalation.
- Turn dysfunctional conflict into functional conflict.
- Seek help if the conflict is overwhelming.

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