



*SCCE's 7<sup>th</sup> Annual*  
**Compliance & Ethics Institute**

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## **Auditing & Monitoring**

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## **Agenda**

- The Role of Auditing and Monitoring in Organizational Governance and Compliance
- Monitoring and Auditing and the Levels of Control
- Developing Effective Monitoring Plans and Strategies
- Providing Effective Assurance
- Key Monitoring Tools – Two Examples
  - Hotlines
  - Anti-Fraud Programs



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## The Role of Auditing and Monitoring in Organizational Governance and Compliance



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## Auditing and Monitoring

### Part of Governance Process

#### Provide Assurance:

- Board
- Management
- Stakeholders



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## What is organizational governance?

The process through which

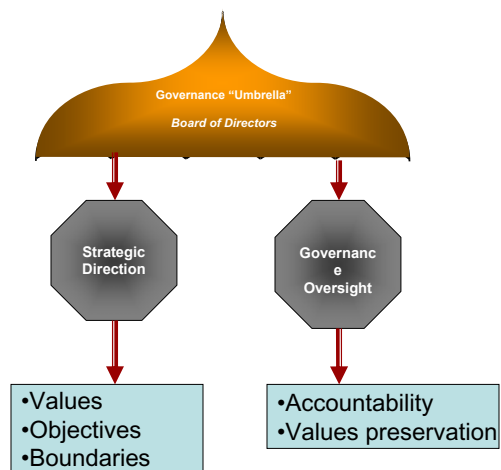
- (1) values and goals are established and communicated,
- (2) the accomplishment of goals is monitored,
- (3) accountability is ensured, and
- (4) values are preserved.



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## The Two Basic Responsibilities of the Board



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## Key Components of Governance Oversight



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## Creating an Ethical Business Culture – Dual Role

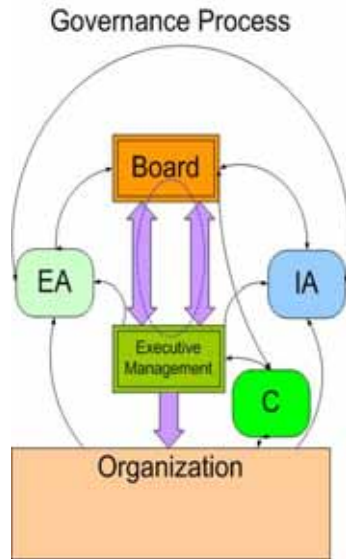
- Strategic Direction
  - Set boundaries
  - Set objectives
  - Establish values
  - Determine risk appetite
- Oversight
  - Risk management
  - Assurance



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## Parties in the Governance Process



- Oversight group – board and committees of the board
- Stewardship group – executive management
  - Dual role of stewardship of resources allocated by board and accountability of results of operations
- Performance group – operating and support management and staff
- Assurance group – internal and external auditing functions
  - and in some organizations - compliance.

## Board's Role

2) (A) The organization's **governing authority** shall be **knowledgeable about** the content and operation of the compliance and ethics program and shall **exercise reasonable oversight** with respect to the implementation and effectiveness of the compliance and ethics program.

Fed. Sent. Guidelines Chapter 8

## Reasonable Oversight

A director has a duty to attempt in good faith to assure that

- (1) a corporate information and reporting system exists, and
- (2) this reporting system is adequate to assure the board that appropriate information as to compliance with applicable laws will come to its attention in a timely manner as a matter of ordinary operations.

*In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).



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## The Management's Role in Compliance

To ensure that all operations are conducted in accordance with applicable law, regulations and policies, including internal policies.

Compliance Programs are designed to establish a culture within a organization that promotes prevention, detection and resolution of instances of conduct that do not conform to federal and state law, as well as the organization's ethical and operations policies.

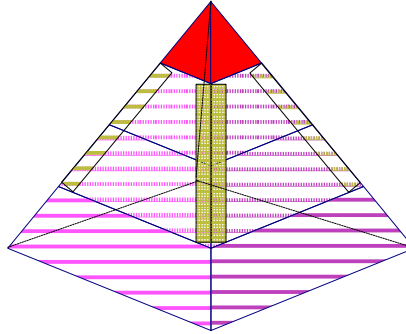


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## Management's Responsibility

### Internal Control – COSO Model

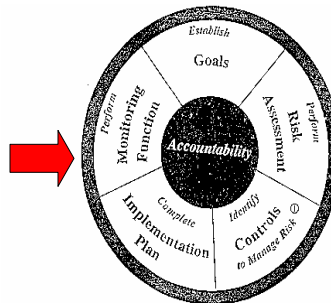


## Internal Control

...a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations.

COSO



## Federal Sentencing Criteria for effective compliance program – 7 minimal requirements

#5. The organization shall take reasonable steps—

- (A) to ensure that the organization's compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct;
- (B) to evaluate periodically the effectiveness of the organization's compliance and ethics program; and
- (C) to have and publicize a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation.



## Monitoring and Auditing and the Levels of Control



## Monitoring

- a process that assesses the quality of the internal control system's performance over time



## Why Monitor?



## Monitoring

- A process that assesses the quality of the internal control system's performance over time
- Types

	Non-independent	Independent
Periodic		
On-going		



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## Auditing

- Type of monitoring
- Independent
- Two kinds
  - External Auditing
    - Financial statements
    - Financial accounting internal control system – SOX 404
  - Internal Auditing



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## Internal Auditing

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations.

It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

The Institute of Internal Auditors

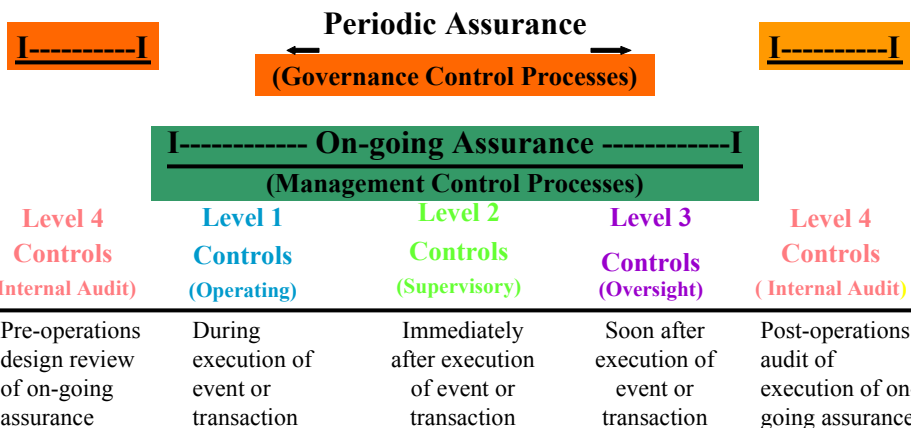


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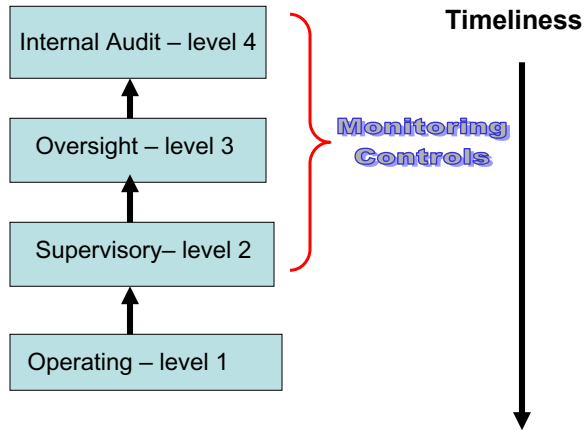
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## Assurance Continuum Levels of Control in COSO

**Collaborative Assurance**  
(Governance and Management Control Processes)



## Effective Monitoring



## Developing Effective Monitoring Plans and Strategies



### Designing Effective Monitoring Functions

- Monitoring is a way to evaluate effectiveness, efficiency and consistency of operational controls
- Benefits of monitoring is process improvement, identification of new risk, assurance
- Monitoring (especially internal audit control) should not be the operating control



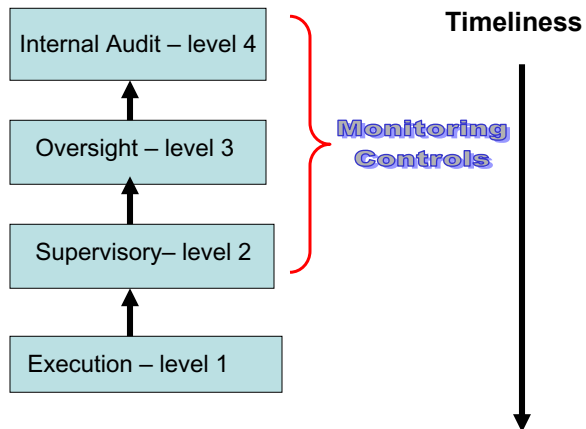
### Developing Effective Monitoring Plans and Strategies

- Link to organization's ERM if one exists
- Link to compliance risk assessment

Other requirements?



## Control and Monitoring Activities



## Create Monitoring Plans

- Include all of the control activities that operate on the critical risks
- Categorize each control activity by level of control (Level 1, Level 2, or Level 3)
- Correlate any Level 2 or Level 3 control with the appropriate Level 1 control
- Indicate the documented evidence created at each level of control



## Audit and Monitoring Plan

Risk	Impact	Prob	Ranking	Risk Response Strategy	Execution Controls Level 1	Supervisory Controls Level 2	Oversight Controls Level 3	Audit



## Monitoring Plan

Maintenance (1, 7, 9, 10)	Operating (Level 1) Control	Evidence of Operating(1) Control	Supervisory (Level 2) Control	Evidence of Supervisory(2) Control	Oversight (Level 3) Control	Evidence of Oversight(3) Control
Insecure facility					Mgr. Walkthrough	Memo of exceptions noted in walkthrough and actions taken; signed and dated
Unlicensed facility	Preventive maintenance schedule	Preventive maintenance schedule	Supervisor reviews completed maintenance	Supr. Signs & dates report with notes	Spot check of equipment by Mgr.	List of equip. checked; Memo to file; Sign log on equip.
	Training of employees	Training roster, certificates, curriculum	Comparison of training log to list of employees	Report of exceptions signed and dated	Exception report to Mgr. About emps not attended	Manager initials and dates with comments of actions taken
	Checklist of tasks	Completed checklist signed & dated by employee performing task	Supervisor verifies & signs checklist	Memo or notes on exceptions noted and actions taken; signed and dated		
	Security check on staff ins & outs	Log of ins and outs that failed security check; signed by security				



## Providing Effective Assurance



## Providing Assurance

- Monitoring Controls need to be auditable
  - Responsibility for monitoring assigned
  - Plan in place
  - Verifiable (documented)
- Goal is to do internal audit of monitoring and oversight controls with little time on operational



## Providing Assurance – Audit Criteria

- Documented evidence of actions taken when monitoring controls identify failure
- Instances of non-compliance documented and dealt with appropriately
- Instances of non-compliance reported to Compliance committee or Chief Administrative Officer
- Documented training related to risk been provided to all employees
- Documented training provided in each case of failure of operating controls or non-compliance
- Periodic reporting to compliance officer and committee



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## Audit Program Development

- **Validate highest level monitoring controls and verify lower level monitoring and operating controls**  
for example:
  - Step to verify Level 3 control followed by
  - Step to verify associated Level 2 control followed by
  - Step to verify associated Level 1 controls (discovery sample only) if Level 3 and 2 are verified and
  - Step to verify Level 1 controls (detailed testing) if Level 2 controls cannot be verified



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## Auditing Compliance System Effectiveness

Part 1 - The assessment of the entity level controls over the compliance program which at a minimum would include evaluating the organization's process for assessing risk of noncompliance and ethical misconduct and the design and implementation of seven elements of the Guidelines.

Part 2 – Evaluating the effectiveness of controls specifically designed to reduce the risk of noncompliance in the high risk areas identified by the organization's risk assessment process.



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## Case

Review SHR Case Part 1

**1. What monitoring processes has SHR implemented to address the above business risk regarding ethical conduct?**

**2. What additional monitoring would you suggest?**



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## Case

Review Part 2

**3. What are the strengths and weaknesses of the entity-level controls over the company's ethics program?**

Strengths

Weaknesses

**4. Based on the results of internal audit's review what would you conclude overall about the effectiveness of entity-level controls over SHR's ethics program?**



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## Case

Review Part 3

**5. Based on your review of the policy above, what would you consider the strong points of the policy and what, if any, shortcomings did you notice?**

**6. Develop a plan to monitor compliance with the Gift Exchange Policy. Identify how you could provide assurance that the monitoring was effective?**

Control (Level 1)	Evidence	Monitoring Supervisory (Level 2)	Evidence	Monitoring Oversight (Level 3)	Evidence



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## Key Monitoring Tools – Two Examples

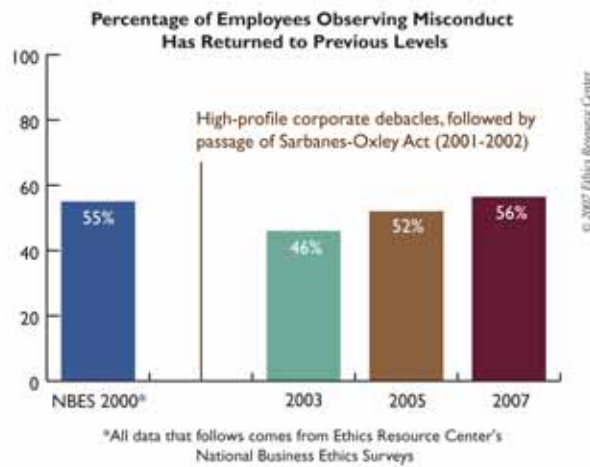
- Hotlines
- Anti-Fraud Programs



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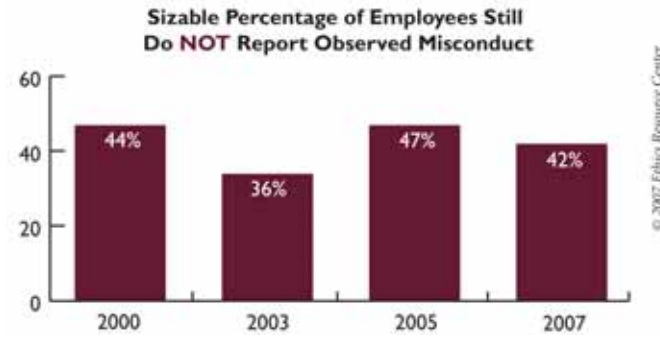
## Many employees report observing misconduct



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...However, many employees do not report misconduct



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## Ethics Risk Index

**Rate of Misconduct**

**+**

**Rate of Reporting**

**=**

**Level of Ethics Risk**

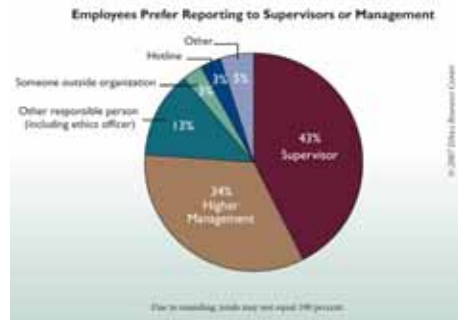


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## Hotlines are a best practice

- Hotlines have proven to be a valuable tool in detecting noncompliance.
- 49% of frauds were reported through tips, more than any other method of detection.
- However, note that employees appear to prefer reporting misconduct to their supervisors or management.



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## Best practices for hotlines

- 24 hour, 365 day access.
  - 48% of hotline calls happen outside of business hours
  - Employees, suppliers, customers, others – ACFE recommends going beyond employees
- Skilled interviewers.
  - More likely to generate actionable information
  - Human interaction gets better information than web forms
- Prompt reporting.
  - Where? Ethics, compliance, internal audit, HR, Legal, risk management, security. Often a decision chart depending on type of call.
- Anonymity
  - Not all are anonymous. Half provide their names and 1/3 report that they have already raised the issue internally with management
- Promoted with education and awareness.

Note: Source for much of the information and ideas in this hotlines section is The Network, Inc. [www.reportline.net](http://www.reportline.net)



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## Areas for improvement

- Centralize lines if there are multiple lines for multiple purposes.
- Data aggregation and reporting is not always optimal.
- Training and promotion are important to hotline success.

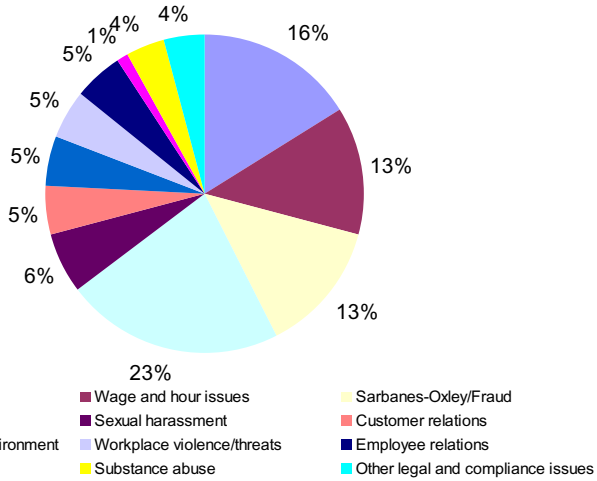


## Step 1: Planning for the Hotline

- Plan to provide:
  - Full time access
  - Skilled interviewers
- International calls – language and access
- Data security



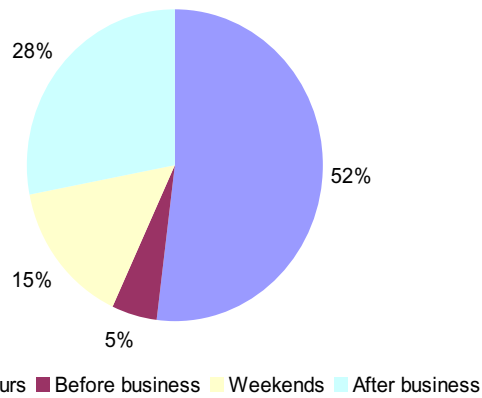
## Types of calls



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## When are calls received?



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## Step 2: Communicating about the Hotline

- Top down
- Shared understanding
- Documentation
- Recognition
- Forward strategy



## Key messages

- Expected behavior
- Behaviors not condoned
- What if you become aware of unacceptable acts—what should you do?
- How to access the anonymous hotline
- What happens with your call



## A proper launch is key to success

- Sets tone
- Lets existing employees and others know
- Need to let new employees and others know going forward
- Keep the hotline top of mind



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## Step 3: Responding to the Hotline Call

- Report dissemination
- Ongoing communication with the reporter
- Investigation of allegations
- Tracking the treatment of complaints
- Management reports



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## Going to a supervisor

- This is a good practice
- BUT, need to communicate to ethics officers the issue, because the issue may be a bigger trend, and the individual supervisor will not see the bigger trend.



## Having a committee is often better than an individual

### Representatives

- Compliance
- Internal Audit
- Human Resources
- Legal
- Provides more consistency



## Hotlines are one of your key monitoring tools

- Other tools
  - Supervisors and management
  - Exit interviews
  - Annual surveys
  - Other monitoring and auditing



## Key Monitoring Tools – Anti-Fraud Programs



## ***Fraud is Alive and Well!***

**Societe Generale SA says bets on stock index futures by a rogue trader caused a \$7.2 billion trading loss.**

**FBI states that its mortgage fraud caseload has doubled in the past three years to more than 1,400 pending cases.**

**Major international airlines pay criminal fines totaling \$504 million for participating in a multi-year conspiracy to fix prices.**

**Siemens internal review identifies questionable payments of up to €1.3 billion.**

**Healthcare fraud costs Americans an estimated \$54 billion dollars annually.**



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## ***Facts on Fraud – PwC's Economic Crime Survey***

- 45% of companies reported falling victim to fraud in the past two years
- In two years, there has been:
  - a 71% increase in the number of companies reporting cases of corruption & bribery
  - a 140% increase in the number reporting financial misrepresentation
- Fraud that led to a loss of assets cost companies—on average—over US\$ 1.7 million: a 50% increase in 2 years
- 40% suffered significant loss of reputation, decreased staff motivation, and damaged business relations
- Over one third of these frauds were discovered by accident, making "chance" the most common fraud detection tool.

**We have to do better!**



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### ***Facts on Fraud - “Collateral” Cost of Fraud is Significant***

- Intangible assets critical to business can be undermined by the occurrence or even the perception of fraud
- Impact on intangible assets can be more important than the direct financial loss
  - Internal intangibles - Staff morale
    - Employees begin to question leadership, governance, ethics
    - Undermine staff loyalty
  - External intangibles - Reputation
    - Regulators and customers
    - Business relationships



### ***Anti-Fraud Program Benefits***

- Enhance prestige among board and management
- Safeguard organizational brand value and individual reputation of members of board, management, and internal audit
- Reduce operational and other business losses in high risk markets
- Mitigate legal liability and reputation loss, if misconduct arises
- Lower SOX implementation costs
- Meet IIA, SEC, PCAOB, DOJ and other standards & requirements for antifraud programs & controls



## ***Need to Know Fraud Related Laws, Regulations and Professional Standards***

- Evolution of SEC Registrant Requirements
  - Foreign Corrupt Practices Act (Anticorruption, Accounting)
  - Sarbanes Oxley Act of 2002
  - SEC Guidance to Management
  - PCAOB Auditing Standard 5 (AS5)
- US Sentencing Guidelines, Chapter 8 Criteria of Effective Ethics & Compliance Programs
- COSO Internal Controls & COSO Enterprise Risk Management



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## ***Anti-fraud Implications of SEC Guidance to Management***

- Explicitly requires management to conduct fraud risk assessment of corruption, fraudulent financial reporting, asset misappropriation;
- Recognizes risk of material misstatement due to fraud exists at any organization regardless of size or type
- Endorses COSO for Small Business, Principle 10 (Drafted by PwC)
- Entity level and pervasive elements of ICFR include:
  - Management override controls
  - Entity level risk assessment process & monitoring activities
  - Controls over the period end financial reporting process



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## PCAOB AS5 Standard's Management Responsibilities

- Programs and controls must be designed and implemented to prevent, deter, and detect fraud
  - Evaluate antifraud programs and controls
  - Identify controls intended to address fraud risks having a material effect on the company's financial statements
  - Identify fraud of any magnitude if it involves senior management or employees who have a significant role in the company's internal control over financial reporting
- Emphasizes importance of antifraud controls and Fraud Risk Assessment (AS5 ¶14 & 15)
  - Management's anti-fraud controls
  - Ability to override controls
- Eliminates prescriptive approach of AS2

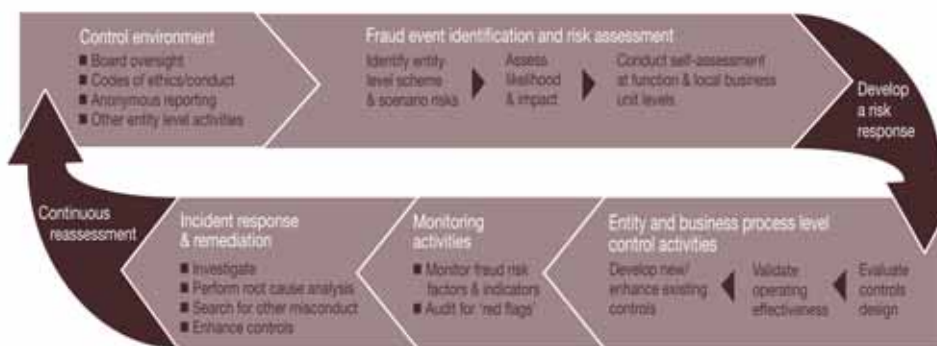


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## How Mature is Your Company's Anti-fraud Program?

Figure 1:  
PwC antifraud framework



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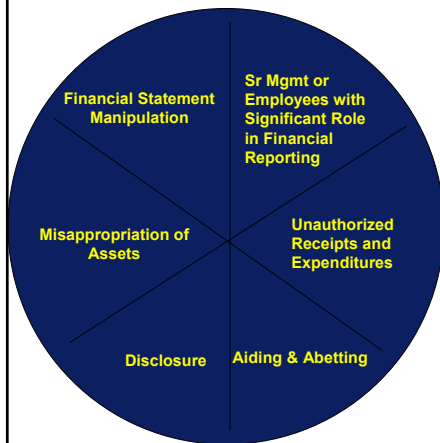
## Fraud Categories, Schemes and Mechanics



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## Fraud Categories, Schemes and Mechanics



**Reputation Risk** (reputation loss to Board or the Organization due to misconduct by employees or strategic vendors)

**Operational Risk** (lost earnings or ineffective business processes, e.g., credit card fraud)

**Compliance/Legal Risk** (potential criminal, civil or regulatory liability – note overlap though with U.S. Sentencing Guidelines)

**Reporting Risk** (non disclosure or false disclosure)

**Strategic Risk** (fraud and misconduct risks associated with new products, services and strategic alliances)



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## Understanding the Universe of Fraud Risks



### Hot SEC/DOJ Areas

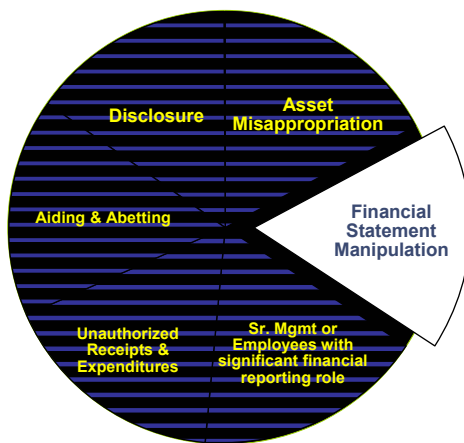
- Fraudulent acquisition of assets
- Bribery
- Aiding & abetting
- Disclosure fraud



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## Understanding the Universe of Fraud Risks: Financial Statement Manipulation



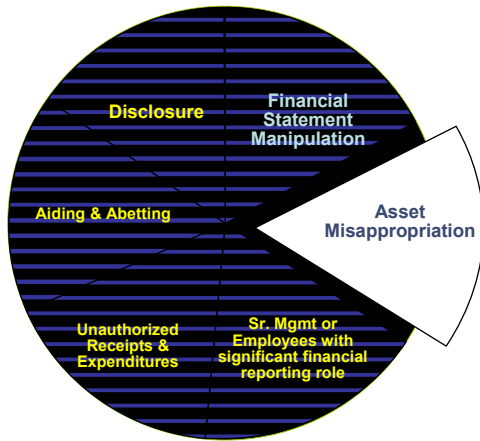
- Improper Revenue Recognition - Before Full Performance Has Occurred
- Holding the Books Open for Extended Time After Period End to Include Additional Revenues
- Recording Fictitious Transactions
- Backdating Agreements
- Improper Capitalization of Expenses as Costs of Fixed Assets
- Misstatement of Reserves or Write Offs
- Management Estimates - Worker's Compensation, Pensions and Other Post Retirement Benefits, Mark-to-Market Accounting
- Management Override of Financial Statement Controls
- Manipulation of Intercompany Accounts
- Manipulating Significant/ Unusual/Non-Routine Transactions



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## Understanding the Universe of Fraud Risks: Asset Misappropriation



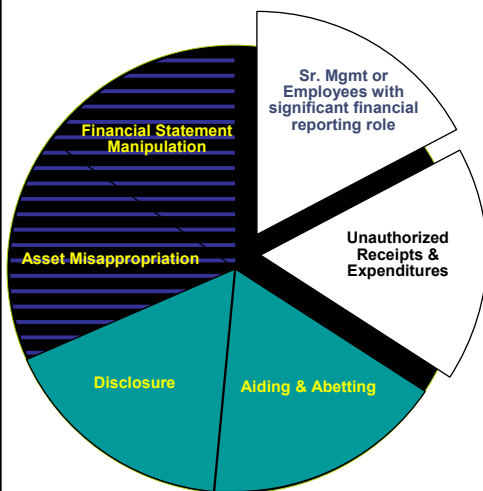
- Cash defalcation
- Inappropriate affiliate transactions
- Theft of goods or services
- Procurement card theft or related inappropriate purchases
- Fraudulent vendors or vendor overpayments
- Misappropriation of cash through treasury or hedging transactions
- Payroll or benefits expense fraud
- Customer/vendor and employee collusion
- Theft of information (company, customer, employee or other)



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## Understanding the Universe of Fraud Risks: Senior Management or Unauthorized Receipts/Expenditures



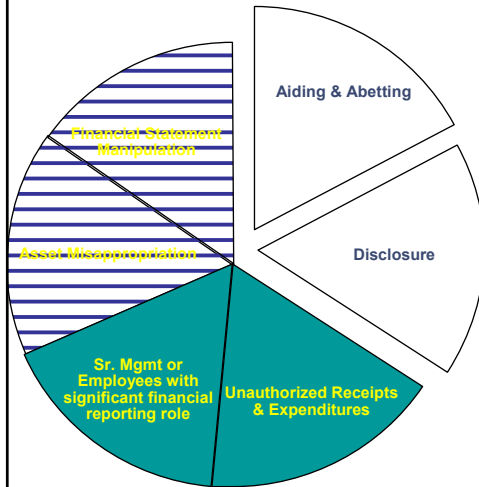
- **Financial Misconduct by Senior Management or Employees with Significant Role in Financial Reporting**
  - Expense account fraud and compensation abuse
  - Conflicts of interest
  - Inappropriate receipts of goods or services from vendors
  - Misuse of corporate assets or insider trading
  - Options backdating
- **Unauthorized Receipts and Expenses**
  - Bribery or inappropriate treatment of government officials
  - Improper related party transactions
  - Avoidance of regulatory required costs
  - Improper allocation of costs



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## Understanding the Universe of Fraud Risks: Aiding and Abetting or Disclosure



- **Aiding and Abetting**
  - Management doing something in response to inquiry of something started by an outside 3<sup>rd</sup> party
- **Disclosure**
  - Failure to disclose channel stuffing
  - Failure to disclose asset problems
  - False environmental reporting or sustainability reporting



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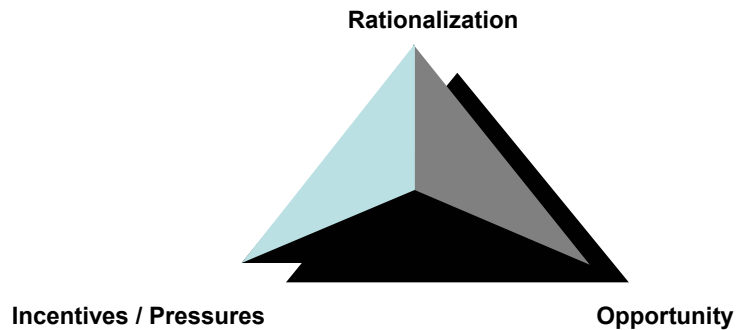
## Identifying and Assessing Fraud Risk



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## ***Conducting Fraud Risk Assessment: Leveraging the Fraud Triangle***



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## ***Identifying and Assessing Fraud Risk***

- **Systematic Rather Than Haphazard or Informal**
- **Likelihood & Significance**
  - “Reasonably possible”
  - “Significant” financial statement impact
- **Management Should Identify Processes, Controls, and Other Procedures That Are Needed to Mitigate Identified Risks**
  - e.g., approvals, authorizations, verifications, reconciliations, segregation of duties, reviews of operating performance, background investigations, physical security
- **Align with Sarbanes Oxley 404 Work**
- **Cover at All Levels in All Functions**



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## Sample Inventory Gathering Techniques

- Industry research
- Existing event inventories
- Brainstorming
- Focus groups
- Web-based and other surveys
- Process flow analysis
- Field interviews and focus groups



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## Assessing Likelihood & Significance of Fraud Risks

**The assessment then considers likelihood of occurrence and significance (business impact) of each risk identified, applying Auditing Standard No. 5 categories:**

- **Likelihood**
  - Remote (R), Reasonable Possibility (RP) or Probable (P).
  - Measure inherent likelihood, i.e., without regard to existing controls.
  - Consider whether any incentives or pressures exist that would motivate fraud or misconduct - fraud and misconduct generally do not occur, absent a motivation.
- **Significance**
  - Inconsequential (I), Significant (S) and Material (M).

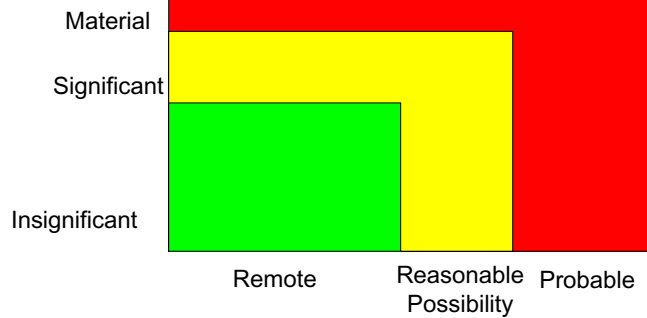


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## Conducting the Fraud Risk Assessment: Assess Likelihood & Significance

### Impact to Company



### Inherent Likelihood



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## Fraud and Misconduct Risk Workshops at the Process Level

- Fraud and Misconduct Risk Identification
  - Consider the potential pressures, opportunities, risks in each process
  - Have all participants prepare for the “Brainstorming” session
- Identify Fraud Schemes Related to each Fraud Category
- Assessment of Likelihood, Significance and Pervasiveness
  - Prepare financial and other relevant data to use when considering likelihood and significance
- Link Control Activities to Fraud Risks Identified
  - Prepare relevant control matrixes to identify key controls
- Identify and Document Management’s Response
  - Consider history of self-assessments, monitoring, internal audit plan



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***Think Like The Devil When Assessing the Risk of Fraud!***

What would the Devil do if he/she was an employee?



What would happen if the Devil was a customer or supplier?

What would the Devil do if he/she was a customer?



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**Activities**



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## ***Fraud – Who will be next?***



## ***Activity #1 – Table Activity***

Select one organization from within your group

- Working with others at your table, select the Five Most Important Fraud Risks in the Organization
  - Don't forget to consider collusion, circumvention and management override
- Evaluate Design Effectiveness of the Existing Controls in the Company
- Consider the Procedures Used to Validate Operating Effectiveness
- Prepare to Share the Procedures You Used



### Activity #2 – Group Activity

- What are the 5 top fraud, misconduct, and corruption risks that your organization faces?
- What fraud and misconduct policies and procedures does your organization currently have in place?
- What is your organization doing well?
- What can be improved with respect to mitigating these fraud and misconduct risks?
- What monitoring process does your organization have in place?



### Activity #3 – Group Activity

Fraud Scheme	“Angels”	“Demons”
Financial Statement Manipulation		
Unauthorized Receipts and/or Disbursements		
Asset Misappropriation		
Senior Management		
Disclosure		



### ***Representative Fraud and Misconduct Program:***

- Policies and Programs – Approved, Posted - Business Conduct Compliance Program, Internal Control, Fraud Detection and Prevention Program
- Code of Conduct
- Compliance Training
- Certification of Compliance
- Whistleblower Hotline
- Ethics and Anti-fraud Surveys
- Compliance Committee
- Training on the detection and prevention of fraud risk.
- Fraud Risk Assessments – Entity Wide and Process Level
- Internal Audit focused projects



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### **Final Thoughts**

**Each Organization Should Consider Its Optimal Approach to Monitoring reflecting on the following:**

COSO – Guidance on Monitoring  
Exposure Draft June 2008



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### Each Organization Should Consider Its Optimal Approach to Monitoring

1. Many organizations are performing effective monitoring in certain areas, but are not fully utilizing the results.
2. Monitoring considers how the *entire* internal control system addresses meaningful risks, not how individual control activities operate in isolation.
4. The board has important responsibilities in monitoring internal control and in mitigating the risk of management override.
5. Internal audit, through added skills and objectivity, can play an important role in assisting management and the board in monitoring.



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### Each Organization Should Consider Its Optimal Approach to Monitoring

6. Organizations should follow a systematic process in determining “what” and “how” to monitor.
7. Judgment is required in determining both (a) optimal approach and (b) effectiveness.
8. Monitoring generally includes the use of both direct and indirect information.
9. Monitoring can be performed using either “ongoing” monitoring activities or “separate evaluations.”
10. Computerized applications have undergone substantial development and can provide a high degree of continuous monitoring.



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