

SHR Corporation: Monitoring***Part 1**

SHR Corporation is a midsize, publicly traded direct marketer and retailer of outdoor sporting goods based in the United States. Its common stock is listed on the New York Stock Exchange under the symbol "SHR."

The company prides itself on selling high-quality outdoor sporting goods at competitive prices and providing outstanding customer service. SHR directly markets its merchandise through two major channels, its catalogs and its website, to customers in the United States and nearly 100 other countries. It currently has retail stores and distribution centers in the United States, Canada, and Europe. A sales force is responsible for dealing with buyers at both the wholesale and retail levels.

SHR Corporation recently purchased MVF Company, a manufacturer of high quality outdoor sportswear. The manufacturing process involves the use of technology-based machinery to cut cloth into various sizes, sew the cloth to conform with the size requirements of the sportswear, and use a series of dies and chemicals to ensure the colors meet consumer expectations and wants. SHR also purchases merchandise from highly reputable vendors in the United States and several other countries.

SHR Corporation has enjoyed several consecutive years of sustained growth as reflected in the selected financial information, expressed in millions of dollars, presented below:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Total Assets	\$700.5	\$546.5	\$491.3
Sales Revenue	763.5	665.7	589.8
Operating Income	57.5	45.0	38.9
Net Income	34.3	29.0	26.0

Senior management is continuing its efforts to grow the company, increase its market share, and enhance shareholder value by:

- Further expanding its direct sales globally,
- Systematically increasing the number of retail stores, and
- Selectively acquiring other businesses that are aligned with its core competencies.

Increasing competition over the past several years has motivated management to continuously pursue new and innovative ways to differentiate SHR's products, streamline the company's business processes, and take full advantage of advances in information technology. Operating efficiency is a critical component of SHR's competitive pricing strategy.

The risks that concern senior management the most heading into fiscal 2008 include the following:

- The anticipated economic slowdown may decrease discretionary consumer spending, which in turn will adversely affect the company's sales and profitability.
- Mounting competition in the industry may make it increasingly difficult to differentiate the company's high-quality merchandise at prices consumers are willing to pay.
- Deterioration of the company's brand or its positive image in the marketplace may adversely affect sales and profitability.

* Adapted from Redding, et al., *Internal Auditing: Assurance and Consulting Services*, Altamonte Springs, FL: The Institute of Internal Auditors Research Foundation, 2007, Case Studies 1 and 2.

- Failure to successfully integrate newly acquired businesses may adversely affect the company's performance.
- The inability to generate operating efficiencies and leverage information technology may adversely affect the company's profits.
- Placing too much emphasis on operating efficiencies may adversely affect product quality and customer service.

During the first six months of 2008, SHR has experienced slower sales growth and higher operating expenses than anticipated. There is growing concern that forecasted performance targets for the year will not be achieved.

The concept that "ethical behavior is good business" is integral to SHR's strategy. For example, the company's 2007 annual report includes the following statement: "Sound ethical conduct is a key component of how we do business and continues to contribute significantly to the company's success."

An illustrative business objective and associated business risk that reflect the company's philosophy regarding ethical conduct are expressed as follows:

Business Objective: To demonstrate sound ethical conduct in everything we do.

Business Risk: Disregard for sound ethical principles, either intentional or unintentional, may cause managers and employees to cut corners, embellish performance results, misuse company resources, or otherwise act in a manner that harms the company and its stakeholders.

SHR Corporation has a reputation of sound ethical conduct. In recent years, however, the company has not had to deal with an economic downturn, the level of new competition it is now facing, or the decreasing profitability it has experienced during the first two quarters of 2008.

Three years ago, the company put in place a comprehensive, written code of conduct (the Code) that is applicable to directors, management, and employees. The code is posted on the organization's website and intranet. All new employees receive a copy of the Code when they are hired and participate in orientation training that includes coverage of the Code. Some minor revisions were made to the Code during the first few months after its introduction, but no changes have been made since then.

A whistleblower program that includes an anonymous hotline was put in place last year for employees and third parties to report suspected violations of the Code. The vice president of internal audit and her direct reports receives the reports from the whistleblower hotline and report suspected violations of the code to appropriate levels of management and/or the audit committee. Calls on the anonymous hotline have been infrequent, with very few suspected Code violations of a significant nature being reported to executive management or the audit committee.

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

2. What additional monitoring would you suggest?

Part 2

The internal audit function (internal audit) recently surveyed executive management and the audit committee regarding the company's ethics program and conducted follow-up interviews with the audit committee chair and selected members of the executive management team. These procedures produced the following information:

- The audit committee's charter does not include an explicit provision for overseeing executive management's ethical conduct or monitoring its adherence to prescribed internal control policies and procedures. The audit committee chair is confident, however, that any misconduct on the part of executive management would come to light via the company's whistleblower program and the committee's quarterly meetings with the vice president of internal audit.
- The executive management team informally holds each other accountable for complying with the Code.
- Executive management believes that it clearly conveys the importance of ethical conduct and compliance with the Code via e-mails, webcasts, and town hall meetings.
- Executive management's assessed level of inherent ethical misconduct risk has remained consistently low over the past three years.

Internal audit separately surveyed a sample of managers and employees regarding the company's ethics programs. 75% percent of the survey recipients responded. This survey produced the following information:

- All company personnel are required to certify in writing on an annual basis that they understand and are in compliance with the Code. Follow-up procedures performed by internal audit indicated that 80% of managers and 90% of employees submitted the fiscal 2007 certification.
- 50% of the respondents said that they referred to the Code one or more times during 2007.
- Managers commonly discuss business ethics during employee performance evaluations, but written performance evaluation standards do not include ethical conduct criteria. No formal provisions exist for rewarding personnel who demonstrate sound ethical behavior or for disciplining those who demonstrate unethical behavior
- Managers and employees are unenthusiastic about using the anonymous whistleblower hotline, largely because they see no evidence that appropriate actions will be taken to address unethical conduct.
- Periodic ethics training is encouraged but not required. The company offers no ethics training in-house other than that provided to new employees.
- Managers and employees in general believe that executive management is ethical. They also believe, however, that executive management does very little to inform them about the company's ethical policies. Less than 50% of the respondents could recall hearing or reading anything about business ethics from executive management during the first six months of 2008. A smaller percentage was aware of executive management's "ethics is good business" statement in the 2007 annual report.
- One manager included a written comment in his survey response indicating a perception that executive management appears to be preoccupied with the lackluster performance results the company is achieving.

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

Strengths	Weaknesses
1)	1)
2)	2)
3)	3)
4)	4)

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?

**Part 3
Test of Compliance with SHR’s Gift Exchange Policy**

Given the growth in SHR’s sales force around the world, as well as management pressures to continue sales growth during more difficult economic times, the internal audit function decided to include an audit of the company’s gift exchange policy in the annual audit plan. The objective of this audit is to evaluate compliance with the policy and recommend improvements which may help to ensure ongoing compliance in the future.

SHR’s Gift Exchange Policy is summarized below:

Creating and maintaining good relationships with our customers, suppliers, and business partners are important to SHR’s success. The occasional exchange of gifts, meals, and entertainment of small value are a common business practice meant to provide a legitimate opportunity to interact, create goodwill, and establish trust.

However, it’s important to use good business judgment when determining the appropriateness of a gift, meal, or entertainment. Business gifts that are extravagant or would influence you are inappropriate and should not be accepted. An inappropriate gift might cloud your objectivity and decision making. Gifts given with the intent to bribe, kickback, or place undue influence are illegal and not the way SHR conducts business.

An appropriate business-related gift is:

- Of moderate value, whether given or received.
- Something that will not embarrass or discredit the company.
- Not made in cash or cash equivalent such as checks, money orders, stock, and similar items.

Gifts, meals, or entertainment that you receive that have an actual or estimated value of over \$500 must be reported to the Chief Compliance Officer.

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