

# Framework for Corporate Culture and Integrity



GLOBAL**COMPLIANCE**SERVICES

# **A Framework for Corporate Culture and Integrity**

## **Abstract**

Corporate fraud has assimilated itself into our dominate business culture; however, in the wake of the recent increase in legislation and guidelines, corporate ethics is taking on increased prominence.<sup>1</sup> This white paper offers a brief overview of the recent corporate climate and the government and organizations' responses to corporate misconduct. In doing so, it will mention the Sarbanes-Oxley Act of 2002, but place most of its emphasis on the recent amendments to the Federal Organizational Sentencing Guidelines and how they effect organizations.

The white paper offers guidance to organizations seeking to adhere to the Guidelines through the use of a competent system to detect and prevent corporate misconduct. Herein are outlined the nine elements necessary to develop, implement, and maintain a framework for corporate culture and integrity. The white paper also outlines the benefits of such a program. Only through early detection and continued adherence to legislation and regulations, as well as instituting an ethical corporate culture can organizations effectively combat corporate fraud and other occupational wrongdoings.

## **Introduction**

Despite the cataclysmic predictions of computer systems and other process-related disasters, the world escaped the Y2K millennium change relatively unscathed. However, the following years, specifically 2001 and 2002, became a real disaster for many U.S. accountants and auditors, as well as business, and financial markets. Although it has become a hot topic in the wake of such public corporate scandals as Enron, Tyco, and WorldCom, corporate fraud is not a new phenomenon. Businesses and government alike have been combating fraud since the 1930s. In the corporate scandals of 2001 and 2002, Murphy's Law became the dominant phenomena as many large corporations were accused of fraud, poor corporate governance policies, or careless accounting procedures. The press, the Securities and Exchange Commission (SEC), and members of Congress all declared that auditing and corporate governance practices needed to be fixed.

Public Accountants and their professional organization, the American Institute of Certified Public Accountants (AICPA), received much of the initial criticism. The AICPA was responsible for financial auditing, and it governed public accounting quality standards through a peer review process. Because of Enron and other subsequent failures, members of the U.S. Congress felt the existing process of establishing auditing standards and monitoring public accountants was inadequate. Amidst resistance from the AICPA, the Sarbanes-Oxley Act (SOX) was passed in 2002, which implemented the most sweeping set of financial auditing changes in the United States since the Great Depression of the 1930s. SOX has generated strong new regulations for public accounting and corporate governance.

Corporate Compliance Programs are also not a new concept, but in light of recent events, they have taken center stage in the war on fraud. The Department of Justice (DOJ) has long indicated the need for organizations to adopt effective compliance programs. In 1991, the United States Sentencing Commission enacted the Organizational Sentencing Guidelines, which specified that the compliance program was the primary means by which organizations could reduce potential criminal punishment after an indictment. The DOJ, the Department of Health and Human Services (HHS), and the SEC have since identified the central role of the compliance program in securing leniency from regulators after misconduct and wrongdoing.

The Sentencing Commission has recently decided to reestablish the standard for compliance. In April of 2004, the Commission announced new guidelines for obtaining mitigation credit for an effective compliance program. The new guidelines became effective on November 1, 2004. The Guidelines acknowledge that an organization performs primarily through its management and employees. Therefore, an organization may be held accountable for the acts of management and employees taken with the intent to benefit the organization. Organizations may also be held accountable for agents acting on its behalf. In some cases, an organization may be held criminally responsible even for the acts of nominal employees.

## **Fraud in the Workplace**

Fraud is one of the most common violations of corporate compliance. It takes on many forms and occurs millions of times a day in US businesses. Much of it is insubstantial, but cumulatively

can have a detrimental effect on an organization. Some examples include acts that we often take for granted, such as showing up late for work, removing office supplies for home use, taking long lunch breaks, excessively calling in sick, and copying personal papers on the office machine. While these offenses certainly do add up, the more visible and dangerous types of fraud are those schemes by which dishonest members of an organization make attacks on its assets.

Occupational fraud can be defined as the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets.<sup>2</sup> Following the corporate scandals of 2002, the DOJ issued a three-part formal definition of corporate fraud: accounting fraud, self-dealing by corporate insiders and obstructive conduct.<sup>3</sup> Despite the continual increase in legislation, reports of corporate fraud are still on the rise. In their 2003 Fraud Survey, KMPG Forensic documented that seventy-five percent of companies surveyed report they experienced an instance of fraud—13 percentage points more than in 1998. Moreover, the survey indicates that internal controls, internal audit, and notification by an employee are the three leading ways of uncovering fraud, with internal controls being the fastest-growing method.<sup>4</sup>

Fraud is an unfortunate fact of life in business today. It is much more common and costly than most employees and managers realize. In the 2004 Report to the Nation on Occupational Fraud and Abuse, The Association of Certified Fraud Examiners (ACFE) reports several profoundly unnerving statistics about occupational fraud:

- The typical U.S. organization loses 6% of its annual revenues to fraud. Applied to the US Gross Domestic Product for 2003, this translates to approximately \$660 billion in total losses.
- The average fraud scheme lasts about 18 months before detection.
- Even if organizations catch an occupational fraud scheme, they are not likely to recover their losses.

Considering these issues in light of the penalties leveraged by US legislation, it becomes clear that the most cost-effective way to deal with fraud is to prevent it.<sup>5</sup> The ACFE also discovered that 60 percent of occupational fraud detection can be attributed to tips from employees about the

fraudulent behavior. In addition, 20 percent of the tips came from customers, 16 percent came from vendors, and 13 percent came from anonymous sources.

## **The Sarbanes-Oxley Act of 2002**

The President signed SOX into law on July 30, 2002. The Act mandates that an organization's management provide accurate and timely financial information to investors. Compliance requires management to file a statement with the SEC confirming that adequate financial reporting controls are in place and to document these controls. The act makes senior management accountable for the organization's financial reporting, and the SEC is committed to enforcing its requirements.

## **Amendments to the Sentencing Guidelines**

In April of 2004, the United States Sentencing Commission voted to amend the existing Organizational Sentencing Guidelines in order to toughen the criteria for effective compliance and ethics programs. The amendments became effective on November 1, 2004. As a result, greater responsibility is being placed on directors and executives for the oversight of compliance programs. The Commission intends to stress two primary concepts that define the effectiveness of a compliance program. To have an effective compliance and ethics program, an organization shall—

1. Exercise due diligence to prevent and detect criminal conduct; and
2. Otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance within the law.<sup>6</sup>

One of the concessions that the Guidelines provide is that the law will reward organizations that maintain effective compliance programs. When an organization is penalized, that base fine is multiplied by the culpability score to determine the actual fine. Each organization begins with a base score of 5 points, which can go up to a maximum of 17 points or down to below 0 points depending on the characteristics of the organization and its past history. The Guidelines have a fairly extensive set of tables to determine these score increments and decrements. If a sentencing judge concludes that an organization has an effective program in place to prevent and detect fraud and other violations of the law, the judge will subtract three points from the organization's culpability score. A well-run organization should earn a culpability score of zero or less.

Therefore, the Guidelines not only prescribe rigid, mandatory penalties for corporate crime, they are structured to change the way organizations do business. The new emphasis on corporate culture enforces a new paradigm.

## **A Framework for Corporate Culture and Integrity**

In accordance with governance reforms enacted by the Organizational Sentencing Guidelines, along with the mandates of Sarbanes-Oxley and other recent regulatory initiatives (i.e., HIPAA, FERC and other vertically specific regulations), Global Compliance Services has identified nine elements necessary for achieving an effective compliance program to detect and prevent criminal conduct and promote ethical behavior.

1. **Code of Ethics or Conduct:** The new Guidelines begin with a focus on establishing standards and procedures to prevent and detect criminal conduct.<sup>7</sup> Effective codes of ethics or conduct are vital to organizations at many levels. They represent a series of supporting rules that define good practices, what is allowed or prohibited. A code of conduct should be a clear, straight-forward set of rules or guidance that states what is expected of the members of the organization, whether officers, employees, contractors, vendors, or any other stakeholders. The code should amplify the organization's overall vision.

Moreover, a code of conduct must be a dynamic document. It has little value if it has been developed, delivered to all stakeholders and then filed and forgotten after the initial launch. Any code of ethics or conduct must be accompanied by an equally prominent and ongoing awareness campaign. The code should be in plain language so as to be easily understood by all members of the organization. Ideally, a code of ethics or conduct should be written at a 5th grade level.<sup>8</sup>

2. **Tone from the Top:** The organization's governing authority is required to 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.<sup>9</sup> An effective compliance program begins at the

top, with the board establishing direction to be carried out by senior management and communicated throughout all levels of the organization. Management must stress ethics and compliance throughout their daily routines.

3. **Education and Training:** Continuous awareness must be implemented to inform employees of the compliance and ethics program. Steps must be taken to communicate standards and train employees, including the upper levels of the organization. Training should include communicating and distributing information on new or amended laws and regulations, as well as changes in internal processes and procedures.
  
4. **Outsourced Hotline (Anonymous):** Under Sarbanes-Oxley and the revised Guidelines, companies must employ an anonymous hotline that allows employees and other stakeholders to report misconduct, fraud, incidents and other concerns without fear of retribution. Moreover, it is important for companies using a hotline to effectively monitor and document follow-up action on such reports. This program should operate independent of management. This independence can be achieved through administration of the program by an independent third party to provide the intake mechanism.<sup>10</sup> In the 2004 Report to the Nation on Occupational Fraud and Abuse, the ACFE reported that organizations that did not have reporting mechanisms suffered median losses that were over twice as high as organizations where anonymous reporting mechanisms had been established.

An effective compliance program should also give employees a way to submit concerns over the web. Corporations have found that some employees are more comfortable reporting concerns over a web page than over the telephone. Supplying multiple methods for employees to report is an important component of a compliance program.

5. **Centralized Data Repository:** To efficiently manage and assess the reporting of misconduct, fraud, incidents, and other concerns, an organization should employ a real-time data repository and retrieval system to house allegation reports.

6. **Data Management System:** An anonymous hotline should be accompanied by a strong case management system to provide a centralized database for documenting the actions taken by an organization to investigate and resolve allegations reported through the hotline. A reporter should be assigned a case number and security PIN to follow up on allegations and to communicate with organizational investigators during the investigation.
7. **Investigation and Action:** Organizations need timely and accurate information to prepare for and manage corporate investigations. Background investigations can be conducted on individuals within the United States on three (3) separate levels depending on the type and amount of information required. The investigative actions should be tailored to each investigation and/or specific client need.
8. **Ability to Query and Generate Reports:** Since it is mandated that internal controls and auditing controls must be continually monitored and reported to board members and senior management, organizations should have a method to conduct real-time queries and analyses of data collected from their hotline and case management systems. This will allow organizations to identify trends and conduct statistical analyses of their program's activity.
9. **Validation, Background Checks:** Performing routine background checks on perspective employees can serve as a first line of defense from hiring someone with a history of unethical behavior. Establishing standards for hiring and promoting the most qualified individuals, with emphasis on educational background, prior work experience, past accomplishments and evidence of integrity and ethical behavior, demonstrate an entity's commitment to competent and trustworthy people.<sup>11</sup>

Likewise, validation, a method of self-assessment, is imperative in preventing fraudulent behavior. Validation runs controlled inputs through organizational systems to measure associated outputs. Mystery shopping is an example of validation. Validation can identify weaknesses in staff performance and recommend training to correct these.

## Benefits of an Effective Compliance Program

Fines for illegal behavior can range from \$5,000 to hundreds of millions of dollars. In addition to avoiding and mitigating monetary penalties imposed under the Sentencing Guidelines, employing an effective compliance program can become paramount to maintaining a strong organization. Effective compliance programs can help an organization to:

- Prevent criminal acts by educating employees and communicating that improper conduct will not be tolerated.
- Reduce the exposure of board members, senior management and employees, and the organization itself, to criminal and civil liability. Benchmarking analysis and research by the General Counsel Roundtable found that each dollar of compliance spending saves organizations, on average, \$5.21 in heightened avoidance of legal liabilities, harm to the organization's reputation and lost productivity.<sup>12</sup>
- Reduce costs related to litigation, fines, negative publicity, and the disruption to operations resulting from investigations and prosecutions.
- Improve its public image by showing that the organization is operating an honest business free from fraud or questionable activities. From a marketing standpoint, the increase in the organization's credibility that accompanies such an image can be an immeasurable benefit in itself.
- Increase employee retention by communicating the organization's commitment to ethical operations and standards. An effective compliance program shows all employees that an organization is serious about working honestly and legally within all aspects of its operations. This can also demonstrate to employees the importance of their jobs and about the prudence of correcting flaws and avoiding illegal activities.

## **Conclusion**

Attempts at corporate malfeasance are not likely to go away in the near future; therefore organizations must arm themselves with adequate measures to combat fraud and other unlawful behavior. An effective compliance program is today's benchmark for the responsible operation of an organization. Such programs are built on a system of risk controls and reviews. Unchecked risk can have an adverse impact on an organization's earnings, capital, and market sustainability, as well as on investor and customer relations that result from non-adherence to laws, regulations, internal policies and procedures, and sound industry practices. Furthermore, unchecked risk could expose the organization to fines, litigation costs, payment of damages, loss of reputation and consumer trust, and impede future business growth.

An effective compliance program is one that reduces the aforementioned risk, promotes operational efficiencies and creates a positive organizational culture. The eight elements of an effective compliance program as outlined in this white paper can assist an organization in developing a program distinctive to its organizational structure. While the complexity of compliance programs may vary according to industry, these eight elements should serve as guiding principles in developing, implementing and maintaining an effective compliance program. The process may sometimes appear to be daunting, but in today's corporate culture, how can you afford to remain at risk?

## **About Global Compliance Services**

Global Compliance Services, the industry leader in outsourced ethics and compliance solutions, empowers corporations to implement internal controls to conform to government and industry regulations and enhance overall business performance. Our portfolio of integrated, end-to-end product and service offerings includes Hotline and Web Reporting, Information Management, Field Research and Employee and Stakeholder Awareness. Founded in 1981, Global Compliance Services has unparalleled experience in ethics and compliance, having introduced the industry's original compliance reporting hotline. Global Compliance Services provides customized solutions to U.S. and international corporations across diverse industries, and is currently serving nearly one-half of the Fortune 100 and one-third of the Fortune 1000.

- <sup>1</sup> Business Ethics and Compliance in the Sarbanes-Oxley Era: A Survey by Deloitte and *Corporate Board Member Magazine*
- <sup>2</sup> See The 2004 Report to the Nation on Occupational Fraud and Abuse available at <http://www.cfenet.com/resources/RttN.asp>
- <sup>3</sup> See A Joint Effort to Fight Corporate Fraud available at <http://www.aicpa.org/pubs/jofa/apr2004/telberg.htm>
- <sup>4</sup> KMPG Fraud Survey 2003 by KMPG Forensic
- <sup>5</sup> See The 2004 Report to the Nation on Occupational Fraud and Abuse available at <http://www.cfenet.com/resources/RttN.asp>
- <sup>6</sup> USSG Section 8B2.1(a)
- <sup>7</sup> USSG Section 8B2.1(b)(1)
- <sup>8</sup> Business Ethics and Compliance in the Sarbanes-Oxley Era: A Survey by Deloitte and *Corporate Board Member Magazine*
- <sup>9</sup> USSG Section 8B2.1(b)(2)(A)
- <sup>10</sup> Key Elements of Antifraud Programs and Controls by PricewaterhouseCoopers
- <sup>11</sup> Key Elements of Antifraud Programs and Controls by PricewaterhouseCoopers
- <sup>12</sup> Integrity Driven Performance by PricewaterhouseCoopers