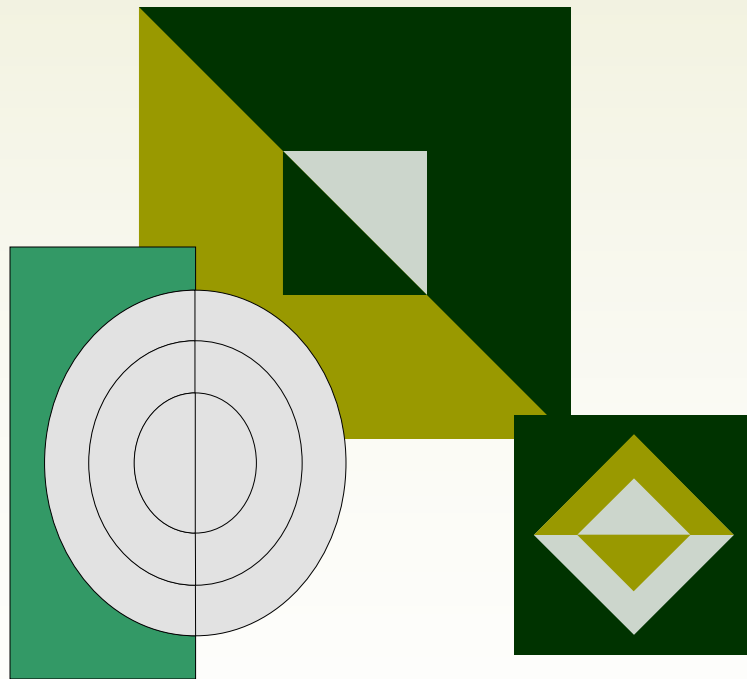




**Lord & Benoit**

Shining Light on Section 404 Compliance

# How on Earth do You Audit Ethics? (under Sarbanes-Oxley)



*Lord & Benoit is a small firm that is preeminent in Sarbanes-Oxley compliance*

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## Background: Shining the Light on Corporate Ethics

America is in a season of shining the spotlight on ethics. Many State Boards of Accountancy are requiring CPAs to take ethics courses each year to renew their CPA licenses. Non-profit organizations, health care and mutual banks and insurance companies are anticipating requirements to comply with a Sarbanes-Oxley (SOX) type standard in the near future. SOX requires the Board of Directors, CEO, CFO and Audit Committees of publicly-held companies to establish a code of ethics and conduct that is subject to audit both internally and externally. The law uses the words ethics, accountability, integrity and transparency in the financial reporting process.

### What is Ethics?

# Ethics

Ethics is a word that infers compliance with a set of rules and regulations. Daniel Webster's describes ethics as "a doctrine of morals," which alludes to a more sensitive word: "character". A person's character will dictate their actions in pressure situations. Character is consistent to a set of values rather than circumstances or situations. It tends to not compromise itself to situational ethics, but responds consistently with one's values, which is usually more difficult.

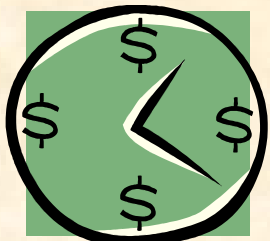
So how do we test character? Here's a simple, easy to remember formula for complying with ethics. This is what I asked one of my sales staff, "If what you are about to say or do, including your intents and motives, would be reported in the New York Times tomorrow, would you still do it or say it?"

### Too Much Ethics, Not Enough Business?

Almost all companies are complaining that internal controls under Sarbanes-Oxley are too costly, with the exception of certain companies like Tyco. Tyco is embracing good management practices, insisting ethical behavior be tied to performance evaluations. Eric Pillmore, SVP Corporate Governance of Tyco International says "We place a *priority* on good internal and IT controls. We believe ethics and good business are not mutually exclusive."

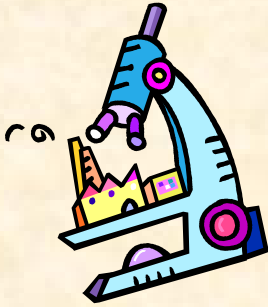


### More Ethics, Less Cost



Most publicly held companies think that going above and beyond in ethics testing is outrageous; adding extra work and costs to an already expensive process. However, companies can *reduce* the number of hours of testing in the activity level if there is a strong control environment. This is an added incentive for companies to establish and maintain a strong and ethical control environment. It actually reduces costs!

## So How Do You Audit Ethics?



Professional standards typically rate levels of assurance from highest to lowest as follows: reperformance, examination, observation and inquiry. However, when it comes to ethics testing the opposite is true. Observation and inquiry creates more assurance. One can get a “sense” of an organization or a person in the organization by looking at body language and evaluating “tones”. We won’t necessarily accomplish our goal by using a yes/no audit program!

- ✦ Questions should be open ended.
- ✦ Non verbal communication should be evaluated and documented.
- ✦ Consider asking the same question in a different way.

The interesting thing is that our friends in the Human Resources department have had a good idea of how to test ethics and integrity for many years now through the interview processes. Perhaps we can glean some information from them? For instance, we can *map* behavior to expected behavior and ultimately to the company’s values and leadership expectations. Any inconsistencies are evaluated and potentially reported on.

## The COSO Ethics Standard



The Committee of Sponsoring Organizations (COSO) has developed an Integrated Framework that meets the criteria of Sarbanes-Oxley [www.COSO.org](http://www.COSO.org). The framework is an iterative, multidirectional process for auditing ethics and other elements of the internal control environment. These are some of the COSO tests relating to ethics:

- ✦ **Written Code of Conduct** -- Is the code of conduct comprehensive? Does the organization address conflicts of interest? Do they address illegal acts? Do they address insider trading? Is the code of conduct acknowledged by all employees?
- ✦ **Tone at the Top** -- Is upper management committed to integrity and ethical values? Do they impose undue pressure on employees? Is there adequate staffing? How they deal with defective products? How do they respond to violations of behavior standards?
- ✦ **How People are Treated** -- How are employees, suppliers, customers, investors, auditors, etc. treated? What kind of pressure is imposed to meet unrealistic performance targets? Are there extreme incentives? Is there too much of a focus on strictly short term targets? Is there training on ethics? Is there on the job training in general?
- ✦ **Attitudes** -- What is management’s attitude toward accounting and IT? What is their attitude toward reliability in financial reporting? What is their communication style? What is their attitude toward overriding controls?

## What's Beyond COSO?



The Sarbanes-Oxley Act requires an annual review of the “tone” at the top. The word, “tone” says it all. The term ‘code of ethics’ in the Sarbanes-Oxley Act says, “such standards that are reasonably necessary to promote honest and ethical conduct.” Although the COSO Framework addresses some aspects of the corporate culture, risk appetite and overall communication of management’s philosophies of ethics, integrity and values, which is a big improvement over anything we have done in the past, I

ask myself, “Would it truly be a preventative control for honesty and ethical conduct?” Would it possibly prevent another Enron or WorldCom? It might, but it might not. I would like to challenge us to pursue the *spirit of the law* a little more. The spirit says, whatever is “reasonably necessary to promote honest and ethical conduct.” Here are some additional questions which I believe are worthy of pursuit:

- ✦ **Encouraging Ethical Conduct** -- Does the company *encourage* ethical conduct? There is a difference between completing compliance questionnaires and embracing the concepts of ethics and integrity. For example, what is the CEO’s response to the purchasing dept that says internal controls don’t apply to them? One CEO of a major insurance company responded to a manager, “If you don’t feel internal controls apply to you, you can be sure the person I replace you with *will* feel it applies to him/her.”
- ✦ **Atmosphere:** Is it an atmosphere of trust? Or is it management by secrecy, undermining, and personal gain? Is the atmosphere one of teamwork or is it every department or every person for themselves? If excellence is a corporate value, is that spirit of excellence in operation? Does management keep its commitments?
- ✦ **Managements’ response:** How does management respond to hotline complaints? Are they tucked under the rug? What is the documented track record?
- ✦ **Ethics mapping:** Are corporate ethics mapped to personnel performance evaluations? Are the behaviors evaluated in addition to the results? Is appropriate consideration given to developing and equipping leaders as it is to results alone?
- ✦ **Modeling ethics:** Does management *model* ethical behavior in word and action? Are their expense reports sending a good or bad message to the accounting staff? Or do they view their management role as a series of entitlements and privileges? How about their behavior outside work? Traveling? Are corporate values traced to leadership values
- ✦ **Standards** - - Does management use the big book for creating ethical standards or is the big book changed each week to allow any kind of behavior? In other words, when a situation has not been addressed, does management look at the law or look to change the law? Do the rules change with people’s behavior or is behavior expected to change to follow rules? Is preference given to certain people or groups of people?



The Open Compliance and Ethics Group has definitely taken the ethics portion to a different level. OCEG has issued an application draft of guidelines that incorporate COSO, ISO and various other legal and regulatory frameworks into their proposed model. They are finalizing a beta test with seven major companies and will issue a final version of the guidelines later this year. You can learn more about them at [www.oceg.org](http://www.oceg.org).

There are many private organizations that provide hands on guidance to promote ethical leadership. One of my favorites is ROI Leadership International [www.roili.com](http://www.roili.com) where Rich Marshall has developed an integrated lifestyle approach towards ethical management. In an integrated approach, there is no such thing as business ethics; there is just ethics – full time.

### The Bottom Line

Auditing ethics is not a check the box, yes or no testing situation. It requires asking thought provoking questions and employing some observation skills typically used in job interview situations. Even the language of ethics auditing can seem foreign to the auditor; incorporating words like “tone” and “transparency.” By learning a few interviewing techniques borrowed from Human Resource Departments, and using the COSO or OCEG framework, the SOX auditor can become an effective ethics auditor.

