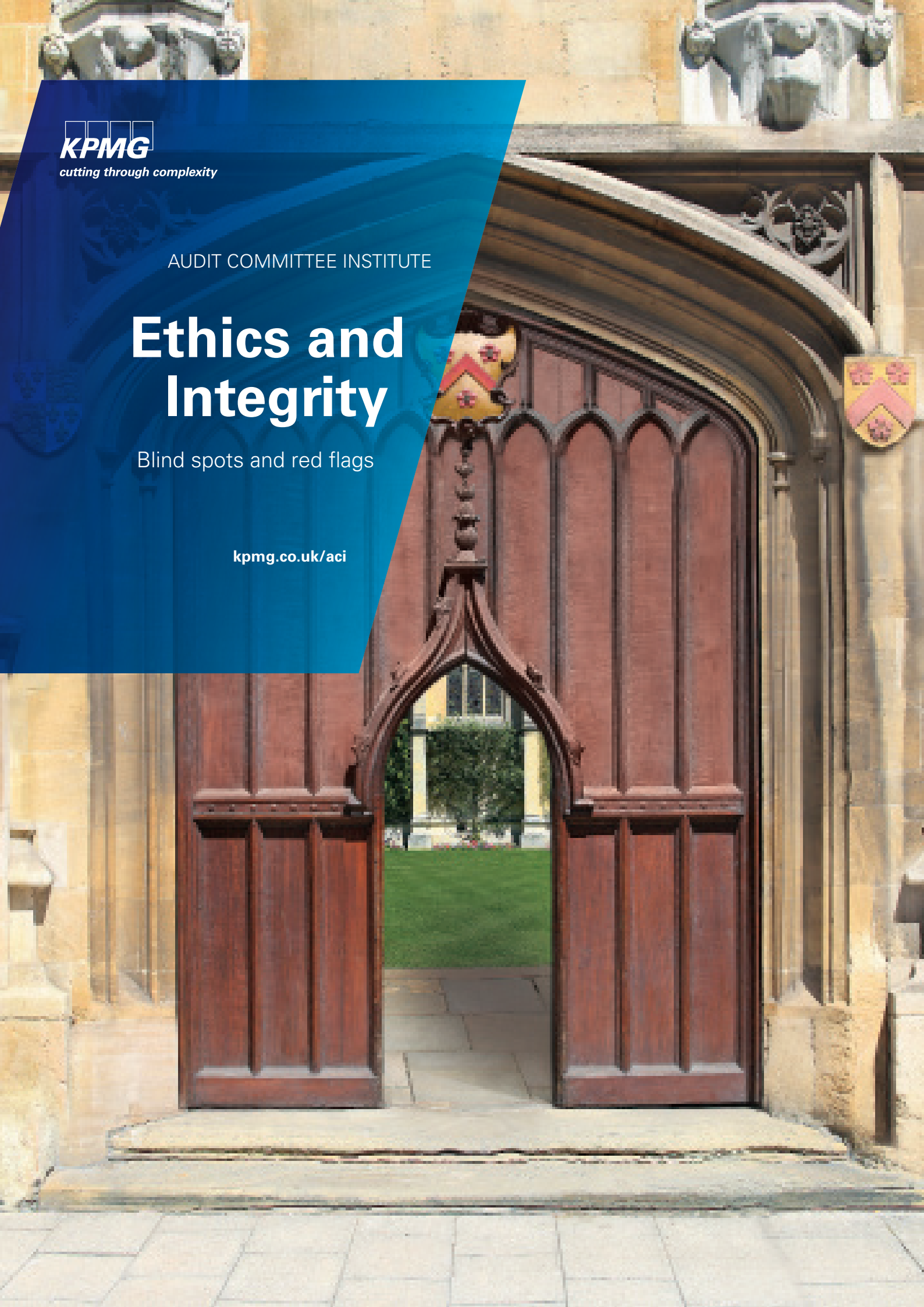

KPMG
cutting through complexity

AUDIT COMMITTEE INSTITUTE

Ethics and Integrity

Blind spots and red flags

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Ethics & Integrity

Blind spots and red flags

Ethics and integrity are fundamental to an effective governance framework and the foundation for developing a culture that supports employee, customer and investor confidence. Notwithstanding compliance with an ever growing set of rules and regulations, if the ethics and integrity within an organisation are below par, then fraudulent financial reporting, reputational damage and business failure is more likely to occur.

Boards of directors and audit committees looking to reassure themselves about their organisations' ethical behaviour might ask the following questions:

- Are we safe?
- Do we need to look beyond existing risk management approaches?
- Why now and why does it matter?
- How do we spot the signals in our business?

Are we safe?

The recent issues with pharmaceutical companies in China are the latest in a long line of front page news stories involving ethics and integrity within global blue chip organisations.

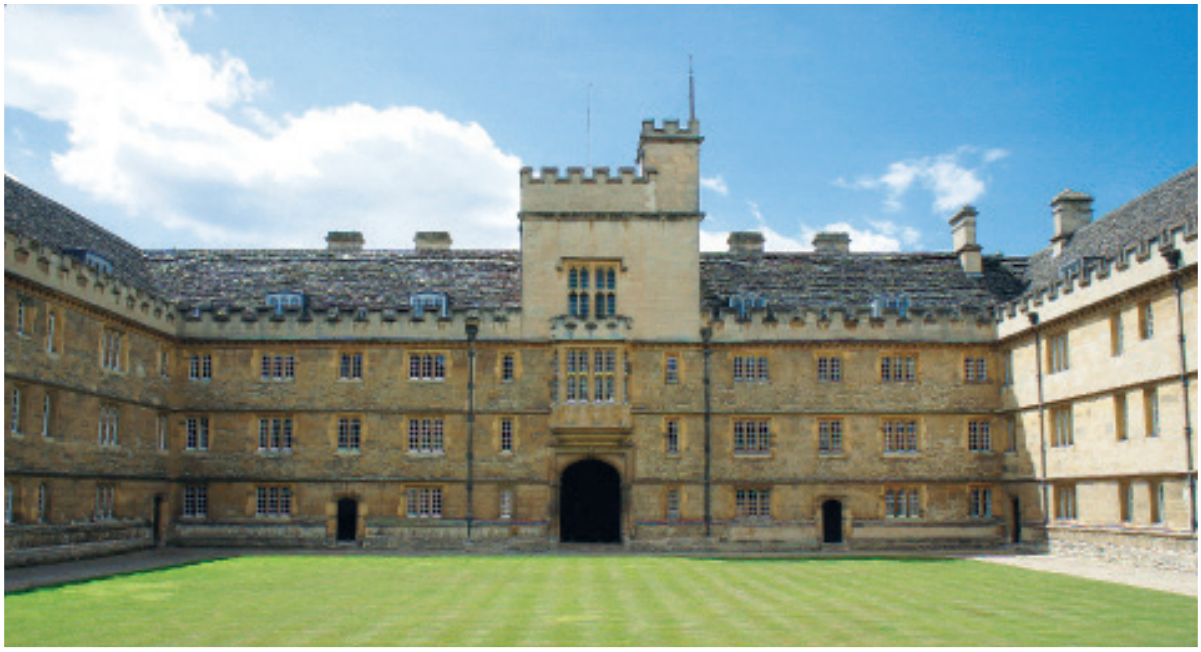
Without a doubt all the companies concerned, irrespective of sector, will have relied on the conventional risk management and governance frameworks embedded in their organisations for the necessary risk assurance. Despite the significant investments deployed in training, awareness, compliance and endless monitoring for significant risks, it may have come as a surprise to senior management that the systems still appear to have failed in some catastrophic way. History shows that such incidents can hit any organisation but often the starting position is "it will not happen to us".

Against this back drop, do boards and audit committees need to learn from the unfortunate experiences of others and ask the question 'how safe are we'?

Do we need to look beyond existing risk management approaches?

Current business risk management models have their place in any well managed organisation. However, most organisations also suffer from blind spots and/or a myopic operational view. With hindsight some have learnt to their cost that conventional risk management needs to be overlaid with an additional level of thinking. This includes, inter alia:

- Recognising that best practice policies, procedures and systems alone will not save the day.
- Not basing everything on trust and assuming that everyone is honest.
- Acknowledging that at any one time somebody will be ready to do the wrong thing.
- Understanding that sometimes good people will do bad things when under pressure; and then rationalise their misconduct as acceptable.
- Noting that the biggest threat to any organisation are the people within it, and it is the senior management that are in a position to cause the most damage.
- Recognising that red flags/signals often exist within an organisation – finding them and joining the relevant dots requires broad and inquisitive thinking.



Why now and why does it matter?

There are a number of macro factors that have been simultaneously at play over the recent past which have amplified the risks within global businesses, adding to the already existing complexity:

- *Economic downturn* – economic pressures are breeding personal stresses (e.g., job insecurity, benefit reduction, reduced chance of promotion, funding addictions and lifestyle maintenance) and driving bad behaviours.
- *Regulatory tsunami* – the ever increasing regulatory burden is leading to fatigue and opaqueness within businesses, while at the same time regulators are becoming more active and sharing intelligence cross borders.
- *Technological change* – in many companies the multitude of IT platforms and increasing volume of data are being exploited to conceal wrong doing; in addition, theft of IP and data through cyber stealth is an increasing issue, and social networks and 24 hour media channels massively accentuate the impact of any incidents.
- *Changing business models* – off-shoring, outsourcing, joint ventures, extended and convoluted supply chains, extensive use of agents and distributors in country and shared service centres have all served to reduce management proximity and control.
- *Restructuring and cost cutting* – erosion of internal controls is a by-product of de-layering, as middle management, who often provide the checks and balances, are removed.
- *Move to high growth territories* – business risk profiles are changing as organisations are moving to higher risk jurisdictions in the pursuit of opportunity, double digit growth and increasing competition in mature markets.

Whilst these factors demonstrate the increasing risk profile, there is at the same time a continuing shift in attitude from consumers, shareholders and regulators. A 'new normal' is now the byword with greater trust, accountability and transparency being demanded.

Furthermore, there is a significant cost to fraud and misconduct. KPMG estimates that a typical global organisation loses five percent of its turnover to fraud and misconduct. Those companies caught up in major incidents cite a number of negative business consequences: substantial amount of senior management time consumed tackling the issue (up to 25 percent), bad press, significant legal and regulatory costs to put things right, potential loss of customers, staff and suppliers, to name but a few.

How do we spot the signals in our business?

To ensure management are sensitised to the various signals within an organisation it is important that they think beyond their own operational/functional 'borders'. Most operating models lend themselves to the disaggregation of risk which, when looked at in the round, may indicate that closer scrutiny is required. To illustrate the point, below are some examples that could well exist within one business unit. When looking at these in isolation, each could ordinarily be considered a separate and immaterial issue but they are in fact connected matters indicating signs of significant problems requiring closer examination.

- *Management* – highly respected, charming but arrogant and domineering management team has been in place for a long time; senior management team resist being promoted despite their success; expat regional managers are culturally and operationally 'in the dark', not clear on the underlying growth success, but unquestioning as seen as a hero by head office; or consistently vague and changing explanations from local management to simple queries.
- *Performance* – the operation always just meets stretching budgets; performance is out of kilter with market forces and competitors.
- *HR* – unusually high employee attrition in a particular part of the business; low staff morale; or unquestioning obedience to local management.
- *Finance* – increased revenues without a corresponding increase in cash flows; or significant and complex transactions at period end.
- *Manufacturing* – unusual level of product returns.
- *Pay and reward* – too much reliance on one KPI to measure success; or an incentivisation model designed to drive business but also the 'wrong' behaviours.
- *Supply chain* – a select group of local suppliers chosen over centrally head office approved suppliers; suppliers paid in advance of service delivery; value of service difficult to measure; or no significant supplier track record even in the local market.
- *Compliance and Monitoring* – internal audit highlights numerous control weaknesses and, when considered collectively, indicates a general disregard for corporate governance.

These are just an example of the 'red flags' that may sit within an organisation.

The external or internal threat of fraud, misconduct, unethical behaviour, and regulatory breaches is a constant risk that latches onto existing weaknesses and has no natural stopping point.

Post mortems of historic incidents have revealed that in many cases there have been more granular, visible and immediate red flags within a function that were missed and the early warning signals (Appendix 1) were not triggered. It is therefore crucial that organisations remain receptive to the more obvious tell-tale signs.

Do you recognise any of the selection of potential warning signs?

The question

Getting the right ethics and integrity embedded within a business is a complex process and this paper is by no means an exhaustive explanation of why bad things happen to good companies.

As a board or audit committee member are you happy that management are reflecting beyond their respective functional borders, are they finding those intelligence dots and joining them, minimising the blind spots and being proactive in avoiding the dangers which have crystallised and wreaked havoc for others.

In light of the experiences of others, what should we be doing differently?

Appendix 1

Red flags

Employee behaviour:

- autocratic management style / domineering decision making;
- obsessive secrecy;
- senior management overrides;
- close relationship with supplier or customer dealt with exclusively by one employee and guarded jealously;
- certain suppliers or customers dealt with outside of the appropriate department;
- certain mundane tasks are retained when they could be delegated;
- evasive or excessively complicated answers to routine queries;
- addictive behaviour;
- bullies or intimidates colleagues;
- ability / performance not in line with CV;
- employment of poor quality staff to supervise;
- tendency to bend the rules / cut corners;
- lifestyle and income mismatch;
- rarely takes holidays; and
- refuses or does not seek promotion.

Cultural indicators:

- overriding management attitude of results at all costs;
- low morale, high staff turnover;
- minor but regular failures to follow company procedure or policies and disrespect for systems;
- passive and unquestioning staff who may be turning a blind eye to irregularities;
- use of a favoured few suppliers /agents;
- habit of protracted discussions with regulators; and
- culture of favouritism and nepotism.

Structural indicators:

- discovery of undisclosed private companies controlled by employees or directors;
- private companies related to the organisation are part of an unnecessarily complex or confusing structure perhaps involving off-shore entities;
- lack of separation between private and public company affairs remote locations which are evasive or provide minimal or inadequate information;
- lack of available management accounts;
- a large number of transactions or excessive profits in a peripheral function which is not closely monitored such as the car scheme, fixed asset sales;
- lack of clear reporting lines or areas of responsibility;
- transactions or structures created with no clear purpose;
- different auditors and different year ends for different parts of the organisation;
- frequent change of auditors;
- unnecessarily large numbers of adjusting journals;
- large number of purchases just below approval limits; and
- lack of segregation of duties.

Business indicators:

- results always at or just above budget;
- results exceed market trend;
- aggressive accounting policies;
- aggressive forecasts;
- regular profit warnings;
- liquidity problems (high profitability not matched by cash flows);
- key missing documentation;
- a subsidiary, department or other part of the business has a poor reputation in the market place;
- increasing number of complaints for products / services;
- reward schemes linked to results; and
- unnecessarily confusing or complex transactions entered into.

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About the Audit Committee Institute

Recognising the importance of audit committees, the Audit Committee Institute (ACI) has been created to serve audit committee members and help them to adapt to their changing role. Sponsored by KPMG, the ACI provides a fully comprehensive professional development programme and is a resource to which they can turn for information or to share knowledge.

For more information on the work of the ACI please click on our web site www.kpmg.co.uk/aci

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