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Ethics and Internal Auditing

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Introduction

Ethics is derived from the Greek word “Ethos” which means “Character.

It signifies the beliefs and ideals of a community, and in the corporate world, it means beliefs and ideals of the company. Ethics and morals not only play a vital role in the success of an organization but also in holding on to its position in the market. Information flow is faster than ever and every new data point of your company makes or breaks it.

Companies are not only required to work hard but need to truly innovate to capture the attention of the fickle technology market, which is seeking the next “big thing”. This industrial vigorous motion of the technology world has evoked great innovations from many companies who have risen to the occasion and proved their value. Some have also produced anecdotes like **Theranos**, which tried to emulate the success of **Apple** in the field of medicine through the leadership of Elizabeth Homes.

Elizabeth Homes offered the world a miracle technology which would have changed medicine forever in the same beautiful package as many other Silicon Valley giants. But it turned out to be nothing more than “snake oil”. **Theranos** was valued at $10 billion US at its peak, by venture capitalists and private funding, but because Homes misled her stakeholders with false information and immoral behavior, it now exists in the history books along with Enron and other fraudulent ventures of the time.

Several other significant CEO departures of 2019 highlighted the significance of the lack of ethical behaviour at the highest levels of the organization. Nike’s CEO, Mark Parker, who held the position of CEO since 2006, left the organization marred by two major scandals, including an executive overhaul and multiple lawsuits over alleged gender discrimination and a "boys' club" culture at Nike. In another example Steve Easterbrook was ousted as McDonald's (MCD) CEO and president after the board determined that he violated company policy and demonstrated poor judgment involving a relationship with an employee.

Importance

With the growing number of reported corporate frauds and misconducts, many organizations have established compliance and ethics programs (Program) to prevent and detect criminal conduct. As organizations establish and implement these programs, they struggle to weave it into their culture to better protect themselves. It is recommended that to incorporate the Program, it should be integrated into a control framework, such as the Internal Control – Integrated Framework of the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Once the controls are established, they must be entrenched into the cultural fabric of the organization.

As a result of various court case rulings in Canada and the US, it has now been established that the courts expect organizations to maintain suitable internal controls and consider it in their decision making.

In an unreported judgment, Pallotta v. Cengarle, Court file CV-16-56337, released on February 27, 2020, Faieta J. found real estate lawyer Licio Cengarle vicariously liable for his clerk's mortgage fraud scheme as well as for breach of trust. The court found Ms. De Filippis to be an employee and emphasized the significant connection between the risk created by Mr. Cengarle having her manage all aspects of his real estate practice, and the fraud that she perpetrated on the Plaintiffs. This risk could have been prevented with greater oversight. [1]

In the recent Marchand v. Barnhill case, the Delaware Supreme Court concluded that a director "must make a good faith effort to oversee the company's operations". Failing to make that effort "breaches the duty of loyalty and can expose a director to liability". For a plaintiff to prevail on a Caremark claim, the plaintiff must show that a fiduciary acted in bad faith. Bad faith is established when "the directors completely fail to implement any reporting information system or controls," or having implemented such controls failing to monitor or oversee. In short, the "board must make a good faith effort – i.e., try – to put in place a reasonable board-level system of monitoring and reporting". [2]

Internal auditors can play a larger role in helping organizations and its boards to monitor controls established to prevent and detect fraud and to help promote ethical conduct throughout the organization. Internal auditors should evaluate whether the current program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees and whether corporate management is enforcing the program or is indirectly encouraging or pressuring employees to engage in misconduct.

Role of Board and Senior Management in Ethics

Boards and Senior leadership set the tone at the top. It is imperative that leadership teams understand the importance of ethics and display the importance in the form of strong policies and conduct. A strong reputation for integrity and high ethical values enhances the brand value and improves the reputation with the stakeholders (e.g. investors, regulators, employees, and consumers).

Managing risk and promoting a strong organizational value system is an integral part of good governance. The reputation of an organization depends on the behaviour and actions of the people in it. Hence good ethical value is a consideration in everything a board, staff and volunteers

[1] https://www.canadianfraudlaw.com/2020/10/ignorance-of-fraud-is-no-defence-employer-vicariously-liable-for-rogue-employee/

[2] https://www.dandodiary.com/2019/08/articles/director-and-officer-liability/recent-delaware-caremark-duty-decision-underscores-board-cyber-and-privacy-liability-risks/

do to establish a strong value system and risk-aware culture in an organization. Strong ethical values sometimes can seem like impediments to success. They require following good practices and procedures, and constant attention to detail. Failures to follow strong ethical values can be more interesting, but also painful and damaging.

The values and standards that must be followed by all are usually set out in an organization's Code of Conduct (Code). The code establishes the boundary of an acceptable behaviour (e.g zero-tolerance policy on fraud, corruption, and bribes) and more importantly, sanctions for lapses. A strong Code reduces the risk and associated costs of fraud and other events that could harm the organization and its brand. An effective code must include a provision for "whistleblowing", thereby giving an opportunity to interested parties to communicate their concerns with confidence.

The code should be approved and overseen by the board to provide it with potency and powers to enforce. Depending on the maturity of the organization and composition of the stakeholders, compliance to code and ethics may be included in organizational goals and employee performance targets. Directors must also sign the code of conduct annually to show that they lead by example.

Role of Internal Audit

IIA Standard 2110 A1.

"The internal audit activity must evaluate the design, implementation, and effectiveness of the organization's ethics-related objectives, programs, and activities."

Key questions to consider

- **Internal Documents** – Are policies, standards and procedures established and promoted towards good ethical behaviour such as a code of conduct? Are they reviewed and approved by senior leadership on an annual basis at minimum?

- **Tone at the top** – Does the governing authority (board of directors) know the content and operation of the Program and exercise reasonable oversight with respect to its implementation and effectiveness? Is the governing authority independent of management, and can it hold the CEO and other executives accountable?

- **Employee onboarding and reporting structures** – Are there good hiring practices established within the organization? Is Human Resources engaged for hiring of all full time or part time positions? Have the organizations established structures, reporting lines and appropriate authorities and responsibilities?

- **Communication and training** – Does the organization maintain a strong internal communications program that constantly sends communication about the objectives and responsibilities for the proper functioning of controls? Are there training activities established for all employees, directors and other key stakeholders?

- **Continuous monitoring** – Does the entity have a system whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation? Is there an ethics/fraud hotline which is monitored by an independent agency?

- **Disciplinary actions** – Does the employee code of conduct include a section on consequences for non-compliance of policies or an act of unethical behaviour? Is there an independent body that investigates and recommends actions against employees and agents that are not in compliance?

Consistent and regular auditing of ethics and morals of a company provides assurance and transparency to the stakeholders to build the confidence and trust in the organization.

History is not there to teach us what happened, but for us to learn and evolve from it.

Conclusion

An organization can be effective in maintaining high ethical standards when its leadership and employees are aware of the organization's expectations and risks that it may face due to non-compliance. The knowledge and awareness of the employees should be supplemented by regular training and updates on ethics related issues. This begins with all new employees undertaking an orientation session which includes information about the corporate culture and the importance of high ethical standards. Furthermore, a committee of the board should monitor all lapses and be part of deciding sanctions against breaches.

Internal Auditing is not just a procedure of checks and balances but it pro-actively monitors and motivates the organization ensuring it thrives on the principles of ethics. It's too late when a whistle blower rises up and raises the concern. Internal Audit should include ethics and culture in its annual audit plan thereby informing the board or its committee about the wrong in the organization.

About the Author

Sanjay is a Partner at SAV LLP and Chief Internal Auditor of the Unisync Group (TSX listed entity). Sanjay is a CIA, CPA, CA, MBA. He also maintains multiple information technology risk designations.

Sanjay leads the Risk Advisory Services division of the firm. The service line includes Internal Audit outsourcing support, Technology audits, Service Organization Control reports (SOC1 and SOC2), PCI SAQ advisory, Penetration testing and Threat risk assessments. For the past 25 years, Sanjay has worked in assurance, risk and advisory services and has served large and small clients, both in the public and private sectors. He has served technology, financial services, health care and mining clients. Previously he worked at three of the Big four accounting firms – KPMG Canada, Deloitte Canada and PwC Canada.