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Advice for Conflict-of-Interest Audits

By José Tabuena — November 4, 2008

Perhaps no other area of business conduct is as fraught with potential peril as are conflicts of interest. In my October 2008 column, I wrote on how abuse of travel and entertainment expenses can hint at bigger fraud problems. We're in luck; similar irregular spending habits can also be red flags for potential conflicts of interests.

The New York Stock Exchange provides a basic definition: A conflict of interest occurs when an individual's private interest interferes in any way—or even *appears* to interfere—with the interests of the corporation as a whole. A conflict can arise when one has interests that may make it difficult to perform work for the company in an objective and effective manner.

You can find conflicts at all levels within a corporation and out in the community. In our neighborhood soccer league, I recently learned that the referee for a game was the uncle of one of the players of the winning team. This little tidbit had not been disclosed, so not surprisingly the losing team protested. In defense, the uncle referee claimed that he couldn't influence the outcome anyway, and that he could be fair no matter which team was playing. Sounds eerily familiar to the physicians who believe that lavish treatment from drug reps does not influence their prescription patterns despite evidence to the contrary.

Human Nature and Conflicts of Interests

Therein lies part of the dilemma. Most agree that companies and employees should avoid conflicts of interests or situations that give the appearance of a conflict. But if you don't *see* the conflict, or you believe the conflict won't impair your objectivity, you probably won't avoid or disclose it. We can be a poor judge of our own biases and generally aren't predisposed to divulge a possible conflict situation.

As you go up the corporate ladder, running into conflicts of interest becomes even more inevitable. Conflicts are likely to occur with accomplished and well-connected individuals who become executives and serve on boards. Clearly corporations can't outright ban conflicts of interests from occurring or business would be difficult to conduct. So what do you do?

Organizations and Conflicts of Interests

Conflicts of interest have received more attention lately because of recognition that many of the recent corporate scandals involved, at their core, a conflict of interest. For instance, the special purpose entities created by Enron (which typically are legitimate structures) involved an inherent conflict of interest with the CFO smack in the middle. Unfortunately the conflict between the SPE and Enron itself, as well as the conflict with the code of conduct, had been conveniently waived by the board of directors. It's also believed that Arthur Andersen's extensive consulting work for Enron may have compromised its external auditor independence and judgment in determining the nature, timing, and extent of audit procedures to be performed.

In the aftermath, Congress and the stock exchanges developed standards and guidelines for instituting codes of conduct and addressing conflicts of interest. Waivers to the code, particularly those involving conflicts of interest, now tend to be viewed with disfavor.

As part of comprehensive changes to its rules on disclosure of executive compensation, the Securities and Exchange Commission adopted a requirement that companies provide disclosure about their policies and procedures governing *related-party transactions*. While the majority of related-party transactions are perfectly normal, the special relationship inherent between the involved parties does create the potential for conflicts.

Awareness of Conflict of Interest Principles?

Most companies now have conflict-of-interest policies that oblige the disclosure of conflicts when they arise; require certification that the employee has read the policy; and further that the individual attests that he has either reported or isn't aware of any violations to the policy. Typically companies use an annual questionnaire that asks the employee to supply information and respond to detailed questions about common scenarios that give rise to a conflict.

Having employees acknowledge and attest to the code and policy can prove handy. Example: A large university fired its financial aid director when it was discovered he owned stock in a company that was being recommended to students and placed on a preferred lender list. It turned out that the director had signed documents acknowledging he understood and agreed to the conflict of interest policy and other ethical standards. Obviously that policy (and certification) was not enough to prevent this director's conduct, and it turned out that there was widespread ignorance among the college's financial aid management and staff about the stated conflict-of-interest principles.

Enter the internal audit department, often working with the compliance and ethics department. This is the group best-suited to monitoring adherence to the policy and assessing effectiveness of the process. Companies should review code-of-conduct provisions and internal policies addressing conflicts of interest, and consider how these will coordinate with a board-level policy for approving related-party transactions.

Auditing Conflict-of-Interest Practices

An audit of conflict-of-interest practices will entail interviews and critical review of documentation to ensure that the objectives of the process are being met. At a minimum, it should be determined whether required individuals understand the policy and are submitting disclosure questionnaires, and if reported conflicts are addressed appropriately. I've seen organizations so focused on ensuring a high completion rate of the questionnaire that they perform only a cursory review of the reported conflicts and related data.

As I hinted at the start of this column, T&E expense reports can suggest potential conflicts of interest. Random and targeted reviews of travel and entertainment expenses, especially on high-volume areas and high-risk departments, may uncover suspicious spending that involves a possible conflict. Likewise, surveying vendors and suppliers can reveal conflict situations where a disgruntled contractor or prospective seller believes a competitor has been unfairly favored. Continual monitoring efforts should be developed to help identify potential red flags. Monitoring activities can highlight risk areas for more focused review. Examples of periodic monitoring include:

- Requiring close review and accountability of expense reports by those with final approval authority.
- Building notification triggers into the expense-reporting process when thresholds or limits are exceeded.
- Developing exception reports for expense and entertainment records and data.
- Reviewing regularly helpline/hotline reports for calls alleging conflicts of interests.

Auditing conflicts of interest can be a challenge, partly because of difficulty in detecting and establishing a negative—how do you identify the conflict of interest that was not reported? Sometimes employees and vendors are your best eyes and ears for non-disclosed situations.

More frequently I see the use of analytic technology emerging as a tool to detect potential conflicts of interests. A data match can be performed between employee and vendor data files to identify relationships that suggest possible conflicts and control weaknesses. The matching would look for employees and vendors with the same address, tax id number, or bank account.

I've used this technique myself, and seen instances where an unexpected relationship between an employee and vendor revealed a conflict of interest that should have been reported, but wasn't. Often the company is surprised to learn that an employee has the same bank account with a seemingly unrelated vendor. In some instances it was more than a policy violation but the committing of procurement and other significant fraud.

There are tools available to the internal auditor to support the company's management of conflicts of interest. An organization that fails to prevent and manage conflicts of interests risks public embarrassment as well as legal liabilities. A company is better served by having policies and guidelines that are well understood by leadership and the workforce. Fortunately there are processes and techniques to detect and monitor for potential conflicts, and to help ensure such issues are appropriately addressed.

ABOUT THE AUTHOR

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