Ethics and Compliance Programs:
*Key Elements of an Effective Ethics and Compliance Internal Audit Program*

Submitted by:
Douglas G. Secrest
Louisiana State University
Center for Internal Auditing
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Topic:
An effective ethics policy is critical to any organization’s governance strategy. Internal audit can add value by periodically auditing this policy. Identify and discuss the key elements of an effective ethics and compliance internal audit program, including what makes them effective elements.

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About the Author

Douglas Secrest was born in Atlanta, Georgia but reared in Baton Rouge, Louisiana where he is currently an honors undergraduate at Louisiana State University expecting to graduate in May 2013. He has completed the requirements to sit for the Certified Public Accountant exam and plans to do so upon graduation. Douglas has successfully completed the Certified Internal Auditor exam and will be certified upon completing the experience requirements. He also has a specialization in internal auditing and is recommended to be deemed a distinguished communicator by Louisiana State University.

Douglas has one year of experience in internal auditing from interning at The Shaw Group in 2011 and Merck in 2012. He is currently pursuing a full-time position within internal auditing before continuing his education where he hopes to receive his Master in Business Administration.
Executive Summary

Ethics is defined as the fundamental principles of appropriate human behavior.\(^1\) Ethical behavior has been a concern since the rise of human civilization; however, in today’s technological advanced world, ethics maybe more important than ever before. When addressing the attendees at the Washington Speakers Bureau\(^2\) presentation, Rusthworth Kidder, the founder of The Institute for Global Ethics, stated,

“What we’re seeing now is a capacity for our technology to leverage our ethics in ways we have never seen before, so that the same unethical impulse that’s been there down through the centuries is now capable of producing global, immediate, and catastrophic effects.” (Kidder, Washington Speakers Bureau)\(^3\)

The 2011 National Business Ethics Survey warns of a decline in workplace ethics due to economic growth and increase in whistleblowing retaliation.\(^4\) Increasing ethical training and education will help mitigate the long-term risk by better preparing the next generation of business leaders to combat ethical dilemmas.

In 2011 the Federal Sentencing Guidelines\(^5\) identified this increased risk and issued minimum requirements for organizations to design, implement, and monitor an effective ethics and compliance program. Internal auditing can play a major role in fulfilling these requirements as well as adding value overall through four key elements of an effective ethics and compliance internal audit program.

Internal auditing should promote a strong ethical culture through a two-fold tone-at-the-top approach by both adhering to The Code of Ethics for the Internal Auditing Profession\(^6\) and maintaining an intense focus on business ethics throughout all internal audit functions. Internal auditing should incorporate ethics risk in its macro and micro risk assessment so that high risk areas are adequately monitored. In addition, internal auditing should continuously monitor the organization’s ethic and compliance programs. Lastly, internal auditing should report back to the governing body and management on the effectiveness of the ethics and compliance programs as well as follow-up on all issues and opportunities for improvement.\(^7\)

\(^1\) Defined by the Business Dictionary at http://www.businessdictionary.com/definition/ethics.html#ixzz2K638GSN7
\(^2\) http://www.washingtonspeakers.com/
\(^3\) Rustworth Kidder, Moral Courage: The Guts of a Tough Decision http://www.youtube.com/watch?v=rb8jSR2aMsE
\(^4\) National Business Ethics Survey is conducted by the Ethic Resource Center and is the only longitudinal study that tracks employees at all levels within organizations. Free download of the study: http://www.ethics.org/nbes/
\(^7\) Key elements are a summary of internal audit responsibilities, functions, and opportunities to add value highlighted throughout the IPPF published by The Institute of Internal Auditors.
Introduction

Over the last few decades, the business world has seen the extent of devastation caused by ethical mishaps. From Enron and WorldCom to Barings Bank, organizations and their investors have lost millions. Historical accounts tell us that today’s society is not significantly more unethical, if at all, than decades or centuries ago. However, the technical advances over the past 20 years have enabled unethical behavior to be leveraged, causing significantly greater damage. This technological leverage poses an increased risk that is further elevated with times of economic growth.

According to the 2011 National Business Ethics Survey (Survey), the immediate future of workplace ethics is likely to decline as economic activity increases. Most corporations are seeing slow but consistent growth after years of the “Great Economic Recession,” and as they grow, most lose focus on ethics. The survey also reports an increase in pressure to behave unethically as well as increased whistleblower retaliation.

With an overall increase in ethics risk, ethical training should also increase. The National Commission on Fraudulent Financial Reporting recommends an increase in ethical training for both students and practitioners to help mitigate the risk for the overall business world in the long-run.

In the short-run, individual organizations can implement an effective ethics and compliance program backed by management’s sincere commitment to ethics to restore and maintain the organization’s ethical health, which is the area that internal auditing has the greatest opportunity to add-value. They can assist in mitigating this risk through an effective ethics and compliance internal audit program composed of four key elements:

- Promoting ethics,
- Assessing and incorporating ethics risk,
- Continuous monitoring, and
- Reporting and following-up.

Internal auditing can provide assurance to the organization’s governing body by promoting a strong ethical culture when adhering to its own code of conduct and maintaining intense focus on business ethical behavior and risk. Then, internal auditing can assess and incorporate areas that have significant ethical and compliance risk in its risk-based audit plan. Next, internal auditing can execute the risk-based audit plan to continuously monitor the organization’s ethics and compliance programs, and thus provide the governing body with assurance of the program’s effectiveness. Lastly, internal auditing can report and follow-up on ethic and compliance issues to engender continuous improvement to the organizations ethical culture and compliance programs.

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8 National Business Ethics Survey download at http://www.ethics.org/nbes/
9 The Dec. 2007 recession was the longest post WWII recession as stated by CNN at http://money.cnn.com/2010/09/20/news/economy/recession_over/index.htm
10 Retaliation increases pp. 16, Pressure increases pp.18 http://www.ethics.org/nbes/
11 Chapter 5: Recommendations for Education http://www.coso.org/NCFR-Summary.htm
12 Companies can reduce their ethics risk, pp. 33 http://www.ethics.org/nbes/
Part 1: Modern Ethical Climate

Ethical dilemmas have troubled humanity since existence. An ethical dilemma is a situational struggle between two values or beliefs so that when adhering to one, the decision maker must ignore the other. Most often, the two values that create the most significant struggle are self-interest and society’s well-being. A strong ethical decision is one that positively advances both the decision maker and society as a whole.

Behavior Is Generally Ethical, Until It Isn’t

Consider the story of Caesar who was betrayed by his closest friend, Brutus. Brutus began to pursue individual motivates and overcame his previous strong sense of moral obligations. Brutus lived a wholesome, moral life, illustrating a commitment to ethical behavior, but in the end, he surrendered to external pressures by killing his dear friend and ruler, Caesar, to appease his brother-in-law Gaius Cassius. This is similar to behavior reported frequently in the media today around the world. Most people have a history of ethical decisions, until a handful of those people lose their sense of moral obligation and succumb to internal and external pressures.

Insight from The Institute of Global Ethics

Rushworth Kidder, the founder of The Institute for Global Ethics, illustrates why ethical mishaps today may pose greater risk than ever before in his discussion at the Washington Speaker Bureau. He describes the story of the “love bug”, a computer virus developed by teenagers in the Philippines, as one of typical mischievous behavior. This virus produced more than $5 billion in damage. Kidder then asks his audience if these kids lack ethics or viciously set out to create so much damage. His answer is simple, “No!” These kids are no less ethical than kids in the 1960s that chased cats and broke windows. Sure the behavior in both cases is unethical, but one is no more unethical than the other. He goes on to state that in today’s society, we are no more unethical than decades, or even centuries ago, but the impact of unethical behavior has grown substantially.

“What we’re seeing now is a capacity for our technology to leverage our ethics in ways we have never seen before, so that the same unethical impulse that’s been there down through the centuries is now capable of producing global, immediate, and catastrophic effects.” (Kidder, Washington Speakers Bureau)

Technology Advances Increase Ethical Risk

Consider the highly discussed scandals of Enron and WorldCom, though highly unethical, not drastically more unethical than the Crédit Mobilier scandal of 1872-1873. However, Enron had a significantly greater impact primarily because of the technology infused world we live in today. When

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13 How Good People Make Tough Choices: resolving the dilemmas of everyday living by Rushworth Kidder
14 http://dcc.newberry.org/collections/shakespeare-rome
17 A scandal where Union Pacific Railroad gave or sold shares to influential congressmen in return for government subsidies to off-set the cost of construction. http://www.history.com/topics/credit-mobilier
Enron reported higher profits, people knew instantly via media coverage and internet usage. Investment banks and other organizations could invest millions of dollars within minutes. When the scandals surfaced to light, technology enabled stock prices to plummet within hours.

The same holds true for Barings Bank which illustrates how a single unethical person can create a significant risk. Nick Leeson single handedly created a $1.4 billion hole in the Barings’ 1995 balance sheet from unauthorized derivatives speculation. Lesson was able to accomplish such tremendous losses via technology infused trading that was not available for the majority of Barings’ 233 years of operation. Leveraging technical resources allows one unethical decision to cause global, immediate, and catastrophic effects. Thus, in today’s technical advanced world, moral hazard poses a greater risk.

\[^{18}\] Leeson is solely credited for the Barings Bank Collapse [http://www.stock-market-crash.net/barings-collapse/](http://www.stock-market-crash.net/barings-collapse/)
Part 2: Ethics and Compliance in the Organization

Carlo V. di Florio, Director at the Office of Compliance Inspections and Examinations at the U.S. Securities and Exchange Commission states, “Ethics is a topic of enormous significance to anyone whose job it is to promote compliance with federal securities laws. At their core, the federal securities laws were intended by Congress to be an exercise in applied ethics. As The U.S. Supreme Court stated nearly five decades ago,

[a] fundamental purpose, common to [the federal securities]… statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry … “It requires but little appreciation … of what happened in this country during the 1920’s and 1930’s to realize how essential it is that the highest ethical standards prevail” in every facet of the securities industry. [2][19] (Florio, 1)

A strong compliance program relies heavily on a strong ethical culture. A compliance program is strongest when the ethical culture of an organization understands and aims to follow the intent of regulation, not simply abide by the minimum standards.

Today’s Ethical Culture in the Business World

The 2011 National Business Ethics Survey, a longitudinal study in its 17th year, reports a decline in workplace ethics for 2011 and expects ethics to continue to decline over the next few years as economic activity increases.20 The Survey discovered that corporations focus more on ethics programs and increase ethical awareness when the economy is struggling. However, as economic activity continues to increase, firms are becoming more optimistic about the future and lose focus on their ethical culture, resulting in a decline of workplace ethics.

The survey continues by highlighting a sharp rise in retaliation against whistleblowers and an increase in the percent of employees who perceived pressure to compromise standards to do their jobs. More than one in five employees that reported unethical behaviors said they experienced some form of retaliation.21 Figure 2.1 illustrates the type of retaliation reported in the survey.

[20] National Business Ethics Survey is conducted by the Ethic Resource Center and is the only longitudinal study that tracks employees at all levels within companies. Free download of study at http://www.ethics.org/nbes/
Figure 2.1: Retaliation More Widespread 2011

<table>
<thead>
<tr>
<th>TYPE OF RETALIATION</th>
<th>2009</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excluded from decisions and work activity by supervisor or management</td>
<td>62%</td>
<td>64%</td>
</tr>
<tr>
<td>Given a cold shoulder by other employees</td>
<td>60%</td>
<td>62%</td>
</tr>
<tr>
<td>Verbal abuse by supervisor or someone else in management</td>
<td>55%</td>
<td>62%</td>
</tr>
<tr>
<td>Almost lost job</td>
<td>48%</td>
<td>56%</td>
</tr>
<tr>
<td>Not given promotions or raises</td>
<td>43%</td>
<td>55%</td>
</tr>
<tr>
<td>Verbal abuse by other employees</td>
<td>42%</td>
<td>51%</td>
</tr>
<tr>
<td>Hours or pay were cut</td>
<td>***</td>
<td>46%</td>
</tr>
<tr>
<td>Relocated or reassigned</td>
<td>27%</td>
<td>44%</td>
</tr>
<tr>
<td>Demoted</td>
<td>18%</td>
<td>32%</td>
</tr>
<tr>
<td>Experienced online harassment</td>
<td>***</td>
<td>31%</td>
</tr>
<tr>
<td>Experienced physical harm to your person or property</td>
<td>4%</td>
<td>31%</td>
</tr>
<tr>
<td>Harassed at home</td>
<td>***</td>
<td>29%</td>
</tr>
</tbody>
</table>

"These trends heighten business risk by increasing ethical misconduct and discouraging reporting, thereby depriving organizations of the chance to identify and fix potential problems before they become significant."  

According to the National Business Ethics Survey, as illustrated in figure 2.2, “the prescription for ethics health is straightforward:

- Invest in building a strong ethics and compliance program; and
- Commit to ethical leadership and building an ethics-focused business culture.”

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22 Documented approval obtained from The Institute of Global Ethics; see bibliography “Drga Abreu, Kalima”; Survey pp.16 http://www.ethics.org/nbes/

23 Documented approval obtained from The Institute of Global Ethics; ; see bibliography “Drga Abreu, Kalima”; Survey pp. 33 http://www.ethics.org/nbes/
These two key factors illustrated in the survey are also echoed by The Institute of Internal Auditors (IIA) Internal Professional Practices Framework as well as The Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Code of Ethics and Management’s Tone

The Federal Sentencing Guidelines provides guidance on effective ethics and compliance programs. The first minimum requirement set by the Federal Sentencing Guidelines is:

(1) The organization shall establish standards and procedures to prevent and detect criminal conduct. (Federal Guidelines, pp.1)

This is often fulfilled with a corporate code of conduct. The Texas Rangers, The Institute of Internal Auditors, and P&G all have a code of conduct and ethical policies, but the policies themselves do not create a strong ethical culture. Management should also commit to embracing ethics in their leadership and communication.

Davidson and Stevens conducted an experimental study analyzing the effectiveness of having a code of ethics, not having a code of ethics, and having management certify the code of ethics. Their study finds that when the code is certified by management it enhances the potential for the code to activate ethical behavior as the norm. The study continues with showing an increase in investor confidence when the code of ethics is certified. The IIA shares similar beliefs as the Tone-At-The-Top December 2012 issue states,

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24 Documented approval obtained from The Institute of Global Ethics; see bibliography “Drga Abreu, Kalima”; Survey pp. 33
26 COSO Internal Control — Integrated Framework http://www.coso.org/IC.htm
29 Certifying the code of ethics is done when the manager publicly certifies that he/she will adhere to the code.
“Executive management’s approach to ethics speaks volumes to the rest of the organization and can have a dramatic impact on the bottom line, both in terms of fraud prevention and- the more difficult to calculate- reputational damage.”

Certifying the code by management illustrates the organization’s commitment to maintaining a transparent, strong ethical culture so that the code is actually effective, rather than simply being a stand-alone policy.

**As Ethics Risk Increases so Should Ethics Training**

As previously discussed, technology increases the modern day risk of unethical behavior. Combining this with the National Business Ethics Survey’s warning of a future decline in workplace ethics, it’s imperative that the next generation of leaders receive adequate training in ethics. Some states in the U.S. require an ethics course for CPA eligibility, which is certainly a significant and tangible move in the right direction, but one 3-credit hour course is limited in the material that it can cover. A more integrated approach would expose practitioners and students to a vast knowledge of ethics within various subjects.

Of course an integrated approach would be harder to quantify than a minimum requirement, but the effect would be significantly greater. Integrated ethics training elevates substance over form and is closer aligned with a principle-based approach.

The first two suggestions for implementing principle-based ethics made by the authors of *Ethics and the Auditing Culture: Rethinking the Foundation of Accounting and Auditing*, an article from the *Journal of Business Ethics* are:

- Mandating the teaching of business ethics to CPA candidates; and
- Mandating that CPAs be required to complete continuing education courses in business ethics to retain their licenses.

The National Commission on Fraudulent Financial Reporting concurs as it “recommends changes in the business and accounting curricula as well as in professional certification examinations and continuing professional education.” The report states, “Education can influence present and future participants in the financial reporting system by providing knowledge, skills, and **ethical values** that potentially may help prevent, detect, and deter fraudulent financial reporting.”

Ethics must become a critical factor of education to combat the increasing risk of moral hazard in the business world. Of course education is not the only step to improve ethics, but it is one that can no longer be ignored.

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30 Fraud and Ethics is the second of eight 2013 priorities The IIA points out in the 59th issue of *Tone-At-The-Top*.
31 Suggestions for implementing principle-based ethics (6 total) pp. 279.
32 Report of the National Commission on Fraudulent Financial Reporting; Chapter 5: Recommendations for Education.
http://www.coso.org/NCFFR-Summary.htm
Part 3: Four Key Elements of an Effective Ethics and Compliance Internal Audit Program

Standard 2110 – Governance

The internal audit activity must assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives:

- **Promoting** appropriate ethics and values within the organization;
- Ensuring effective organizational performance management and accountability;
- **Communicating risk** and control information to appropriate areas of the organization; and
- Coordinating the activities of and communicating information among the board, external and internal auditors, and management.

2110.A1 – The internal audit activity must **evaluate** the design, implementation, and effectiveness of the organization’s ethics-related objectives, programs, and activities.

2110.A2 – The internal audit activity must **assess** whether the information technology governance of the organization supports the organization’s strategies and objectives.\(^{33}\)

Key Element One: Promoting Ethics

As mentioned in the above standard, the first important element of creating an effective ethics and compliance internal audit program is **promoting ethics**. The internal audit department’s tone-at-the-top should be conducted in the same manner as executive management. However, the internal auditing tone-at-the-top is two-fold. First and foremost, it should exemplify its own commitment to ethical behavior by adhering to The IIA’s published Code of Ethics.\(^{34}\) Secondly, internal auditing should maintain an increased focus on organizational ethics to consistently assess, monitor, and report the status of the organization’s ethical culture to the governing body and executive management.

Internal auditing should lead by example in illustrating the upmost ethical standards for its own professional code of conduct. It’s only then, that internal auditing can become a true asset to the business by making a valid assessment and continuously monitoring the ethical behavior of the organization.

When internal auditing consistently focuses on ethics throughout all audit functions and projects, it simultaneously accomplishes several goals set by The IIA. Internal auditing adds value by illustrating executive management’s commitment to ethics as well as properly assessing and monitoring the ethics and compliance programs as suggested by The IIA’s Practice Guide.\(^ {35}\) Internal auditing also gains a

\(^{33}\) IIA IPPF  [https://na.theiia.org/standards-guidance/Public%20Documents/IPPF%202013%20English.pdf](https://na.theiia.org/standards-guidance/Public%20Documents/IPPF%202013%20English.pdf)


thorough understanding of the ethical culture and thus can better incorporate that knowledge into future risk assessments to accomplish a more effective risk-based approach to auditing.

“Check-the-Box” Mentality

Ethical behavior underlines most control processes. Internal auditing should remain focused on the ethical decisions and behaviors being made and avoid a “check-the-box” mentality that simply meets minimum requirements. Such a mentality cost a major pharmaceutical firm, Eli Lilly, over $29 million related to a Foreign Corruption Practice Act (FCPA) violation.

“Kara Novaco Brockmeyer, Chief of the SEC Enforcement Division’s Foreign Corrupt Practices Unit, added, “Eli Lilly and its subsidiaries possessed a ‘check the box’ mentality when it came to third-party due diligence. Companies can’t simply rely on paper-thin assurances by employees, distributors, or customers. They need to look at the surrounding circumstances of any payment to adequately assess whether it could wind up in a government official’s pocket.”

Promoting ethics is one of the most important elements of an effective ethics and compliance internal audit program because it is the underlining element that substantially increases value of the remaining three key elements, and thus significantly increases the effectiveness. It also allows internal auditing to have a fuller understanding of the ethical culture to report back to the governing body and executive management.

Key Element Two: Monitoring Ethics

Practice Advisory 2110-3: Governance: Assessments states,

“The internal audit activity is an essential part of the governance process. The board and executive management should be able to rely on the quality assurance and improvement program of the internal audit activity in conjunction with external quality assessments performed in accordance with the International Standards for the Professional Practice of Internal Auditing (Standards) for assurance on its effectiveness.”

An effective way for internal auditing to monitor is through testing. This testing can be completed through an entity wide assessment of the ethics and compliance program, or by integrating ethics and compliance testing in all audit projects. Either way, internal auditing should directly assess the effectiveness of certain key functions such as misconduct investigations and whistleblower reporting.

“Specific ethics-related functions and activities (e.g., the compliance function, ethics training, and hotline) might be evaluated as part of an entity wide review or as a standalone audit project.” (Practice Guide)

37 PA 2110-3: Governance Assessments https://na.theiia.org/standards-guidance/recommended-guidance/Pages/Practice-Advisories.aspx
A best practice could be to combine a periodic entity wide assessment with continuous integrated ethics and compliance testing.

**Entity Wide Ethics and Compliance Assessment**

As required by The International Professional Practices Framework (IPPF) Standard 1311, internal audit departments must perform “periodic self-assessments or assessments by other persons within the organization with sufficient knowledge of internal audit practices.” Certainly, the ethics and compliance departments could benefit from doing the same. Internal auditing can assist in this process by being the “other persons within the organization with sufficient knowledge;” however, it’s vital that internal auditing objectively analyze its reporting structure. On a few occasions, internal audit departments report to the Chief Compliance Officer. Dalton Smart, Internal Auditing Director for Merck states from a previous experience, “In such case, the organization may benefit more if the ethics and compliance departments use an outside party for the assessment. An outside party brings independence, benchmarking and access to best practices, while internal auditing provides knowledge on the organization’s standards.”

**Whistleblower Retaliation**

“Not only is retaliation on the rise nationally, it is rapidly becoming an issue even at companies with a demonstrated commitment to ethics and integrity.” (Retaliation) Employees are the best indicators of unethical behavior, but they must have a clear way of reporting misconduct without a fear of retaliation. With the addition of the Dodd-Frank Whistleblowing Provision, more employees are willing to speak-up due to the added monetary incentive.

“In any covered judicial or administrative action, or related action, the Commission… shall pay an award or awards to 1 or more whistleblowers who voluntarily provided original information to the Commission that led to the successful enforcement of the covered judicial or administrative action, or related action” (Dodd-Frank, pp. 2)

**Testing Against a Set of Standards**

Testing against an adequate set of standards clarifies and defines the process requirements and then clearly identifies any gaps that may exist. IPPF Standard 2210.A3 states “adequate criteria are needed to evaluate governance, risk management, and controls.” Fulfilling the second key element, monitoring, can be achieved by testing the adequacy of the organization’s ethics and compliance program against the Federal Sentencing Guidelines minimum requirements. It’s important to note that the Federal Sentencing Guidelines are only minimum requirements. Therefore, internal auditing should use this set of standards as a minimum point of reference, but also identify opportunities for improvements and process efficiencies.

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39 IPPF (Standards) 1311 [https://na.theiia.org/standards-guidance/mandatory-guidance/Pages/Standards.aspx](https://na.theiia.org/standards-guidance/mandatory-guidance/Pages/Standards.aspx)
42 IPPF (Standards) 2210 [https://na.theiia.org/standards-guidance/mandatory-guidance/Pages/Standards.aspx](https://na.theiia.org/standards-guidance/mandatory-guidance/Pages/Standards.aspx)
<table>
<thead>
<tr>
<th>Summarized Federal Sentencing Guidelines</th>
<th>Suggested Internal Audit Procedures – IPPF</th>
</tr>
</thead>
</table>
| Establish policies and procedures to prevent and detect criminal conduct. | ➢ Assess the adequacy of the corporate code of conduct to ensure it engenders high ethical practices and expectations from all employees.  
➢ Assess specific policies and procedures in audit projects to ensure their alignment with the code of conduct and ethical integrity of the organization. |
| Establish accountability, responsibility, and direct reporting as it relates to the governing body, high-level personnel, and specific individuals delegated with day-to-day operations of the ethics and compliance programs. | ➢ Assess the governance structure of the organization for clear accountability and identified responsibility of key personnel as it relates to the ethics and compliance program. |
| Performance of due diligence when hiring substantial authority personnel to not include anyone that is inconsistent with an effective ethics and compliance program. | ➢ Assess the due diligence process for hiring employees and contracting with third parties.  
➢ Test to ensure the appropriate background checks have been successfully completed for employees.  
➢ Re-preform background checks on key personnel within the organization. |
| Train and communicate to employees at all levels, the governing board, and, as appropriate, agents on the organization standards and procedures. | ➢ Assess the effectiveness of entity wide ethics and compliance training.  
➢ Test for completeness of training by all levels of employees.  
➢ Review third party contracts to ensure adequate communication and training of the organizations commitment to ethics. |
| Monitor the effectiveness of policies, procedures, and the overall ethics and compliance program. | ➢ Maintain ethical focus in all audit projects to assess the effectiveness of integrated ethics within business processes.  
➢ Monitor the whistleblowing process and identify potential retaliations. |
| Reinforce the ethics and compliance program through incentives for appropriate behavior and disciplinary action for inappropriate behavior. | ➢ Assess performance review process at all levels of employees during audit projects to ensure importance is placed on ethics and integrity.  
➢ Assess the corrective action policies for employees that act unethical.  
➢ Test to ensure individuals that have acted unethically were adequately reprimanded. |
| Continuous improvement for identified weaknesses. | ➢ Recommend program improvements and follow-up on high ethical risk areas.  
➢ Test investigations for adequate responses and corrective actions. |
| Assess the risk of criminal conduct and take appropriate steps in designing, implementing, or modifying existing controls to reduce the risk of criminal conduct identified. | ➢ Assess the ethical risk on a macro and micro level - including employee surveys - and incorporate into risk based audits.  
➢ Follow-up issues to ensure adequate actions for improvement have been implemented. |

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44 Note: This table is not intended to be solely relied on as a reference for the minimum requirements or internal audit procedures, but rather a high level summary to facilitate the desire to gain further knowledge.

45 Summary of the minimum requirements outlined in the Federal Sentencing Guidelines  

46 Summary of Standards, Practice Guides, and other research, all of which is discussed throughout The IIA’s IPPF  
Key Element Three: Assessing and Incorporating Ethics Risk

Practice Advisory 2110-3: Governance: Assessments

Internal auditors are integral to the organization’s governance framework. Their unique position within the organization enables them to observe and formally assess the governance structure, its design, and its operational effectiveness while remaining independent.47

Throughout the monitoring process, internal auditing should identify areas within the organization that have an increased ethics and compliance risk. For example, Suwan Kim, Merck Internal Auditing Associate Director of the Asian market, identified invoice verification in China as an increased ethical risk. “In China, fake invoices are abundant. We cannot simply accept an invoice for face value; we have to verify, through the governmental system, that the invoice is real.” This combined with the 2012 Corruption Perception Index score of 39 makes China a high ethical risk area; 48 therefore, at Merck, the China market is audited through multiple targeted audits each year.

Employee Surveys

“To determine the effectiveness of ethics-related activities, internal auditors must measure the ethical climate itself. One good method for doing this is an entity wide employee survey.” (Practice Guide)49

In assessing the ethical risk of an organization, an employee survey provides tremendous insight. The major components of an effective survey are a focus on ethical issues and attitudes, assessment of employees across levels of the organization, and a sincere commitment to ensure that all responses are confidential.

Assessing risk is vital to all internal audit functions as IPPF Standard 2010 explains “the chief audit executive must establish a risk-based plan to determine the priorities of the internal audit activity, consistent with the organization’s goals.”50 Incorporating ethics in the overall risk assessment is vital to adhering to this standard. When management of a specific business unit or process fails in creating a strong ethical culture, the risk of all other issues increases drastically. Thus, “at a minimum, the internal audit activity should periodically assess the state of the organization’s ethical climate and the effectiveness of its strategies, tactics, communications, and other processes in achieving the desired state.” (Practice Guide)51 Best practices could include a formal ethics component of the risk

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47 PA 2110-3: Governance Assessments https://na.theiia.org/standards-guidance/recommended-guidance/Pages/Practice-Advisories.aspx
48 Corruption Perception Index scale 0 to 100; 100 equals least corrupt. http://www.transparency.org/cpi2012/results
management process that is directly related to the audit plan approved by the board, and could include an assessment of vital components like employee surveys and whistleblowing processes.

**Key Element Four: Reporting Gaps and Following-Up**

“The board of directors … needs assurance that these programs are effective in creating the desired ethical climate throughout the organization. Internal auditing is best positioned to give that assurance because it experiences the ethical climate directly but is independent from management and charged with identifying weaknesses and opportunities for improvement.” (Practice Guide)  

It’s critical that internal auditing maintains open communication with the board about the organization’s ethical culture and the ethics and compliance program’s effectiveness. Federal Sentencing Guidelines deem the governing board responsible for establishing an effective ethics and compliance program (see guideline 2 in Chart 3.1). Internal auditing can add significant value by assessing and then communicating the program’s effectiveness to the governing board and executive management.

When communicating ethics and compliance to the board, The IIA’s Practice Guide warns internal audit departments that “ethics is a sensitive area that does not easily lend itself to traditional audit rating systems. Rather than give an audit opinion on ethics, it might be less inflammatory and more useful to assess the maturity of the various elements of the ethical climate using a maturity model.” The Practice Guide is a valuable resource for determining which maturity level would best suit the organization under examination.

When identifying issues, gaps, or opportunities for improvements, internal auditing should not only communicate such items to the board, but should also follow-up with the appropriate personnel. This ensures actions are being taken to adhere to the Federal Sentencing Guidelines seventh minimum requirement listed above in Chart 3.1, “continuous improvement”.

Reporting and following-up is vital in completing the circular process by directly relating back to promoting an ethical culture and monitoring the ethics program.

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Conclusion

Though ethical concerns have been and remain prevalent in humanity, especially in the business world, today ethics risk may be more important than ever before.

“What we’re seeing now is a capacity for our technology to leverage our ethics in ways we have never seen before, so that the same unethical impulse that’s been there down through the centuries is now capable of producing global, immediate, and catastrophic effects.” (Kidder, Washington Speakers Bureau)\(^{55}\)

However, internal auditing can assist in mitigating this increased risk by implementing an effective ethics and compliance internal audit program.

“Internal auditing is best positioned to give that assurance because it experiences the ethical climate directly but is independent from management and charged with identifying weaknesses and opportunities for improvement.” (Practice Guide)\(^{56}\)

An effective ethics and compliance internal audit program should consist of four key elements;

- Promoting ethics,
- Assessing and incorporating ethics risk,
- Continuous monitoring, and
- Reporting and following-up.

Internal auditing adds the most value and assurance to the organization by promoting a strong ethical culture when adhering to its own code of conduct and maintaining intense focus on business ethical behavior and risk. Identifying and incorporating areas that have significant ethical and compliance risk allows internal auditing to adequately plan its resources according to a risk-based approach. Then, executing the risk-based audit plan and continuously monitoring the organization’s ethics and compliance programs, provides the governing body with assurance of the program’s effectiveness. Lastly, reporting and following-up on ethic and compliance issues engenders continuous improvement to the organization’s ethical culture and compliance programs.

\(^{55}\) Rusthworth Kidder, Moral Courage: The Guts of a Tough Decision https://www.youtube.com/watch?v=rb8jSR2aMsE

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*This table is not intended to be solely relied on as a reference for the minimum requirements or internal audit procedures, but rather a high level summary to facilitate the desire to gain further knowledge.
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