

# THE FRAUD CLINIC

By Tim J. Leech, CA, MBA

## How Well Are You Managing Your Exposure to Conflicts of Interest?

A CONFLICT of interest is any situation, real or perceived, that places in doubt or impairs a person's objectivity, with the potential to jeopardize his or her ability to act in the best interest of the employer, partners, or constituents.

Examples of conflict of interest situations can include:

- An employee who awards a contract to a company which he or a related party owns.
- A politician who votes on a development issue in which he or she has a personal financial interest.
- A purchasing agent who has awarded work to a company that has provided him or her with seasons tickets to the Blue Jays.
- A business traveller who makes an unnecessary trip, makes unnecessary stops or uses a more expensive airline to obtain frequent flier points.

It is impossible to delineate all the possible situations that could constitute a real or perceived conflict.

Conflict of interest situations have the potential to result in serious harm and direct losses to the organization. Such losses are often difficult to detect. Internal audit departments are now being called on to ensure that their companies have controls to minimize the possibility of conflict of interest situations and to detect problems.

Some companies have well-defined policies that provide specific guidelines and advice on the topic of conflict of interest; others have no formal policy. Few companies that I am aware of have comprehensive programs. How does your

company measure up when it comes to managing the conflict of interest area?

***"Strong controls over conflicts of interest are essential to the financial well-being of your organization to minimize the personal liability of your directors and officers and to maintain an effective fraud prevention and detection program"***

As internal auditors we should conduct audits in this area. Strong controls over conflicts of interest are essential to the financial well-being of your organization to minimize the personal liability of your directors and officers and to maintain an effective fraud prevention and detection program.

### Conflict of interest audits

You should consider conducting a conflict of interest audit to determine the controls your company has and to assess their effectiveness. One approach is to view the assignment in terms of four sub-audits:

1. Policy and Standards Audit
2. Policy and Standards Communication Audit
3. Direct Controls Audit Conflict of Interest
4. Compliance Monitoring/Enforcement Audit

The overall audit objective is to assess the effectiveness of the current methods, procedures and mechanisms used to identify, prevent, and respond to situations that involve, or could potentially involve, a harmful conflict of interest.

## **Policy and standards audit**

The primary objective of this audit is to assess the adequacy of existing policy and standards with respect to conflicts of interest. Work done in this section should answer the following questions:

- Has the organization developed a policy and standards for all areas of operations that could give rise to a conflict of interest situation?
- In potential conflict areas where policies or standards do exist, how comprehensive are the policies in coverage, and how clearly do they explain the organization's expectations?
- Does the existing policy provide advice and guidance to employees on where and how to seek assistance should employees feel that they may have a concern about their own or someone else's situation? This step provides coverage for special situations that a policy cannot anticipate.

## **Policy and standards communication audit**

Even the best devised policy must be effectively communicated. This audit should provide answers to the following questions:

- Has the conflict of interest policy or expectations been communicated to staff (formally or informally, on hiring, by video, or in personally addressed statements of values and ethics)?
- Has existing policy on conflict of interest been effectively communicated to all staff?

## **Direct controls audit/conflicts of interest**

The primary objective of this audit is to document and analyze the effectiveness of relevant controls in place. Work done on this audit should answer the following questions:

- Are controls in place to minimize the risk of harm from conflict of interest in respect to:
  1. The acquisition of goods and services.
  2. The provision of goods and services.

3. Hiring practices.
4. Promotion and performance measurement practices.
5. Outside activities and business interests.
6. Political and community activities.
7. Travel and expense policy, including frequent flier affiliations.
8. Other areas relating to your organization's unique activities.

- Are the controls that do exist functioning as intended?

## **Compliance/monitoring enforcement audit**

The primary objective of this audit is to assess the adequacy of current methods, procedures and policies concerning conflicts of interest in minimizing harm to the organization.

Questions to be answered include:

- Are supervisory and management personnel alert and responsive to warning signs?
- Are employees who are caught in breach of the policy being dealt with consistently and in a way that will deter others?
- Are conflict of interest violation firing practices consistent?
- Are honest employees encouraged to come forward when they are aware of violations by others?
- Is the internal audit department adequately trained to detect and investigate conflict of interest violations?
- Are vendor audits performed where billings are on a cost-plus basis? Can these audits detect secret commissions, gifts, entertainment, etc.?
- Are employees required to make written conflict of interest declarations?
- Are there procedures in place to make sure that all declarations are followed up?
- Are the declarations maintained on file for an appropriate period?

This audit program could be expanded to include more points, but the preceding should provide you with enough ideas to design your own custom program. Alternatively, questions relating to conflict of interest can be built into all programs you design, I believe, however, that a direct review of the area is more effective.

Many companies have weak controls in this area and wonder why problems occur with such regularity. Weak controls can be terminal to the health and well-being of your organization. Are you, as head of an internal audit department, properly fulfilling your responsibilities in this area?

In next month's column, I will be discussing how internal auditors should approach an investigation of a real or suspected conflict of interest situation.

*At the time this article was written in 1990 Tim Leech was Managing Director of NCM Control & Security Services Limited, the Canadian subsidiary of an international consulting firm based in London, England. Tim Leech is now Principal Consultant and Chief Methodology Officer at Paisley Consulting, a world leader in business accountability software solutions. He can be reached by phone at 905 823 5518 or by email at [tim.leech@paisleyconsulting.com](mailto:tim.leech@paisleyconsulting.com)*

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