

WORLDWATCH: FRAUD AND REGULATORY ENFORCEMENT



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**Independent evaluation of transactions: the ultimate test of an anti-corruption program**

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Multinational companies invest significant management focus, training time and money to combat corruption and avoid the substantial consequences from violations of anti-bribery regulations. Well-managed companies further comply with these regulations and evaluate the results of this investment and their ‘tone from the top’ in the form of substantive testing. Obtaining and documenting information regarding details of transactions, balances and disclosures to form a basis for conclusions and independently evaluate controls (‘substantive testing’ in the parlance of independent auditors) is the real-world test of whether compliance programs safeguard company assets and avoid regulatory penalties. Substantive testing requires familiarity with local practices and company policies and the ability to efficiently recognise bribes and fraudulent transactions. Therefore, a blended team of a company’s internal auditors and highly-experienced forensic accountants

provides the most effective determination of compliance due to the combination of company-specific knowledge and fraud investigation proficiencies.

**Why is substantive testing a necessary part of an anti-corruption compliance program?**

Rogue employees (acting either alone or in collusion with third parties) may override controls, ignore management’s cultural messages and/or exploit inadequately trained staff to divert company assets and engage in corrupt activities. Additionally, companies may violate requirements to maintain books and records in detail to accurately and fairly reflect transactions *even if there is no intent to bribe or engage in other corruption due to errors*, employee turnover or systems integration issues. Therefore, companies must take the step of substantively testing transactions even when other important aspects of an anti-

corruption compliance program are in place. Substantive testing of transactions is also of great interest to regulators during investigations and prosecution. US enforcement authorities and the UK Ministry of Justice have stated that periodic testing and monitoring of the effectiveness of internal controls is a necessary element of a robust anti-corruption compliance program.

Adverse consequences of non-compliance include fines, penalties, criminal prosecution, reputational damage, debarment from government contracts and significant reduction in share price.

**What do management, independent directors and investors need to know about substantive testing?**

Although senior management, independent directors and investors are unlikely to be involved directly in substantive testing, the oversight by major stakeholders is critical. Effec- ►►

tive and efficient substantive testing requires: (i) a comprehensive anti-corruption risk assessment process; (ii) data analytical procedures to detect patterns and anomalies; and (iii) statistical sampling for testing of transactions and balances in high-risk areas, as well as sampling in low- and moderate-risk areas.

Risk assessment is the process of identifying adverse consequences evaluated in terms of frequency and severity. Consideration of potential violations of the US Foreign Corrupt Practices Act (FCPA), the UK Bribery Act and other country-by-country anti-bribery and record-keeping laws provides a roadmap to identify major areas of risk.

Risk assessment includes addressing company-specific factors. Companies which answer the following questions affirmatively may be able to reduce the number of transactions reviewed and the amount of corroborating evidence required for each transaction. Does the company have effective internal controls in place to detect bribes? Does the company perform background checks on relevant vendors, joint venture partners and employees with payment and business generation responsibilities? Does the company have a well-communicated hotline for tip reporting? Does the company routinely perform analytic review of account balances? Are budget variances identified and reconciled? If manual checks are used, are they subjected to review and audited? Are bank accounts reconciled in a timely manner? Are new vendors approved by employees who are independent of those authorised to disburse funds? Is the cash disbursement function separated from the invoice authorisation process? Are the travel and entertainment expenses of employees with sales, marketing and revenue responsibility evaluated in a timely manner by a qualified independent individual?

Companies which answer the following illustrative questions negatively may benefit from increasing the number of transactions reviewed and the amount of corroborating evidence required for each transaction. Has the company experienced instances of bribery in the past? Does the company operate in countries that are more susceptible to bribes? Does the company operate in industries that are known to foster an environment that tolerates or encourages corruption? Does the company sell to foreign governments or state-owned entities, operate in a highly regulated industry or make payments to foreign customs; foreign police, security or armed forces; foreign tax officials; or foreign licence, permit and certification bureaus? Does the company

use intermediaries such as agents, distributors and outside salespeople? Does the company pay commissions to third parties? Does the company permit facilitation payments? Does the company permit its employees to give gifts and to entertain or provide hospitality to customers and other third parties? Does the company make charitable or political contributions? Do hotline reports, Sarbanes-Oxley testing, internal audit testing and independent audits identify control weaknesses?

Identifying unusual patterns and anomalous transactions helps further narrow the focus for testing. However, pattern and anomaly identification needs to be adapted to the business, industry, country and existing controls. Data analytics programs (standalone or additions to existing Enterprise Resource Planning (ERP) software) can identify: (i) payments in countries other than the country in which the provider resides and/or provides services; (ii) payments slightly under authorisation protocols; (iii) a one-time, unusually large payment; (iv) round sum US dollar payments; (v) an authorising party inconsistent with classification of expenditure; (vi) customer name or address matches or vendor name or address; (vii) vendor payments made to an address in the country of the customer; (viii) payments in foreign currencies; (ix) payments to offshore financial centres; (x) several payments for identical amounts; (xi) manual checks; (xii) a vendor's address at a Post Office Box; (xiii) a payee which is inconsistent with the General Ledger classification for a payment; (xiv) excessive payments to intermediaries; (xv) excessive commissions outside the industry norm; (xvi) payments in excess of budget; and (xvii) excessive charitable or political contributions.

Bribe payments may be so well-hidden that they evade pattern and anomaly testing. Random statistical sampling of disbursements *outside* the pool of high-risk transaction amounts should be employed to select additional transactions for substantive testing to increase the likelihood of identifying bribes.

#### Who should perform substantive testing?

Internal auditors who are independent of company management and possess a strong knowledge of company-specific policies, software, personnel and culture are an integral part of substantive testing of transactions for compliance with anti-corruption initiatives. However, mid-sized and growing companies (and even some larger entities) may lack the internal audit personnel or anti-corruption expertise needed to identify and evaluate sus-

picious transactions. Internal auditors at all companies may be unfamiliar with the impact of expansions into new geographies, regime changes in countries with existing operations or new guidance emerging from other companies' deferred prosecution or settlement agreements with enforcement authorities. Integrating experienced forensic accountants into the substantive testing team can address these gaps. Companies that are involved in a monitorship or active investigation benefit from the inclusion of counsel in the oversight of substantive testing.

Moreover, anti-corruption compliance testing is directed in part to identifying transactions originated by employees familiar with a company's internal controls. Therefore, best practices for substantive testing include not only the incorporation of a random sample as discussed above, but also participation by team members with a heightened awareness of the indicia of corrupt activities. Forensic accountants with a track record of FCPA monitorships, international due diligence assignments and corporate white collar crime investigations routinely address the results of corruption which eluded the efforts of even well-intentioned and compliant companies. Forensic accountants from international firms can also leverage resources in multiple countries (e.g., headquarters, manufacturing locations and home countries of major suppliers).

#### Conclusion

Multinational companies face regulatory imperatives to test the effectiveness of their anti-corruption compliance program. Substantive testing of transactions also enables multinational companies to determine the value and efficacy of policies and procedures, software solutions, 'tone from the top' and training. Best practices build on a company's risk assessment to identify high-risk areas, follow with data analytics to identify patterns and anomalies and incorporate a sampling of random transactions to test for documentation shortcomings and/or employees' ability to evade controls. Substantive testing is best performed by a combination of internal auditors and experienced forensic accountants with a deep background in identifying corrupt activities. Substantive testing not only permits management, independent directors and significant investors to evaluate a company's investment in anti-corruption compliance measures, but also *reinforces* those elements and further demonstrates management's commitment. ■



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