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Employee Hotlines: A Valuable Compliance Tool for the Board

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Now whistleblowing is not just encouraged, it's mandated

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There is no doubt that 2002 was an amazing and horrifying year for the American investor. Investors learned the costly lesson that fraud perpetrated by corporate executives is especially devastating. The year ended with *Time* magazine declaring the "whistleblowers" of Enron, WorldCom, and the FBI as Persons of the Year.

Now reform legislation like the Sarbanes-Oxley Act and the new guidelines adopted by the various stock exchanges have begun a new era of accountability for corporate America. Sarbanes-Oxley dictates the adoption of a tool that lawmakers believe will help audit committees address these issues: employees may submit anonymous reports about financial irregularities without fear of retaliation.

Preventing and detecting fraud is not an easy task, especially for directors, who generally only have contact with a handful of top executives. The Association of Certified Fraud Examiners, an organization that trains people on methods of preventing and detecting fraud, lends insight to the tools that are most effective. In their 2002 *Report to the Nation*, they surveyed thousands of their members and found that tips were the leading method for detecting fraud, accounting for 46 percent of detections. Organizations with a fraud hotline cut their losses by approximately 50 percent per scheme, presumably because the hotline enabled them to uncover fraud much earlier than in situations where other methods were used. While internal audits, external audits, and background checks

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also significantly reduced losses, the greatest reduction in loss was associated with anonymous reporting mechanisms, such as hotlines.

Corporations concerned about employee receptiveness to using a hotline should note that the media coverage of Enron's demise has given employees a heightened awareness of the dangers that fraud poses. In the past there was a perception that financial malfeasance was "none of my business," and employees focused on the risks of retaliation posed by reporting illegal behavior. Now there has been a shift in perception. Employees have seen that deception perpetrated by a handful of people can cost thousands of jobs and rob employees of their retirement savings. Protecting their employer from fraud or theft could enable them to protect themselves.

Fraud Detection Primer for Directors

There are a number of questions directors should ask corporate executives when considering the company's approach to providing the anonymous reporting mechanism required by the Sarbanes-Oxley Act:

Is the company trying to create an ethical environment? While detecting fraud is important, preventing it is even better. The first step in preventing fraud is ensuring that company employees understand that ethical behavior is expected, and unethical behavior is harmful to the company and all its employees. There should be a written code of conduct that every employee receives, and there should be documentation that every employee has agreed to abide by the code of conduct.

Does the company communicate to employees about behaviors that are not acceptable? A comprehensive program includes frequent communication to employees about the behaviors that are acceptable and unacceptable. This communication should permeate the company, from posters in break rooms and articles in

Director Summary: The Sarbanes-Oxley Act mandates employee whistleblower protection. Fraud is detected by tips more than any other method, and professionally staffed hotlines provide an anonymous reporting medium for employees. Directors should ensure systems that allow reporting directly to the audit committee.

employee newsletters to topics addressed at company meetings. This reinforces the employees' perception that the company wants to know about illegal and unethical activities.

How is the company educating employees about the issues addressed by Sarbanes-Oxley? Employees need communication from the company that explains why the activities referenced in the law should be reported: because they are threats to the long-term financial health of the company. Topics should include insider trading, improper loans to executives, accounting irregularities, conflicts of interest, and whistleblower retaliation. Define terms like "accounting irregularities" and "insider trading," which may not be clear to all employees. Finally, emphasize that the Sarbanes-Oxley Act specifically provides for protection of people who report these activities—employees are protected against retaliation.

Do employees know how to report illegal or unethical activities? A common failing of an ethics program is insufficient communication to employees about their communication options. They must be periodically reminded of open-door policies, ethics officers/ombudsmen, and anonymous hotline numbers. It is important to give employees options for reporting concerns, and to make sure they are aware of those options.

Does the company have an anonymous hotline? An open-door policy and a suggestion box are not enough. The financial investment in a hotline is extremely small in comparison to the potentially disastrous results of malfeasance that continues undiscovered. Beyond the obvious financial benefit of stopping fraud in its early stages, a hotline can give the company the opportunity to limit liability regarding offenses such as discrimination. Finally, uncovering and dealing with issues before they are exposed in the media can protect the company from the destruction of goodwill in the eyes of investors, customers, and other stakeholders.

Is the call always answered by a trained interviewer? There is no substitute for human interaction when dealing with an anonymous caller, because there may never be another chance to gather information. Because an anonymous caller typically feels threatened and is in an emotionally charged state, he or she will likely leave out important details. A professionally trained interviewer will ask questions that help the company gain enough information to be able to investigate the allegation.

If there is a hotline, is it run professionally? Many companies set up a hotline number that is routed to a junior employee elsewhere in the company and then sit back and relax, confident that they have a hotline. But calls may not be handled consistently, callers may get voicemail, and employees may not be comfortable calling an internal number or reporting it to another

employee, who they feel might be able to recognize their voice or somehow identify them.

Are complaints received around the clock? To be effective, a hotline must be answered by a live operator 24 hours a day, 365 days a year. Nearly 40 percent of hotline calls happen outside of regular business hours. This is because an employee who wishes to remain anonymous often does not feel comfortable calling from work. He or she will make the call from home.

Are avenues for reporting malfeasance actively promoted to suppliers and investors? If the company is being swindled by a supplier, chances are there are employees working for the supplier who know about it and are bothered by the illegal activity. In the same vein, investors may be aware of activities like insider trading, and publishing the hotline number offers them a convenient way to communicate to the board. Also, informing investors about a hotline number tells them you have complied with this aspect of Sarbanes-Oxley and validates the company's commitment to uncovering fraud. Promoting the hotline number to a wide spectrum of people increases its effectiveness.

If the company is launching a hotline, is there a comprehensive implementation plan? Like any new communication initiative, a hotline will be destined to fail if it is not launched properly. The initial communication should include an announcement by top management about the goals of the program. Information about the program should be posted in break rooms and the program should be introduced in face-to-face meetings wherever practical. Every employee in the company should receive a letter or flyer announcing the program, and ideally this packet should include a business card that he or she can keep in a wallet or purse as a reminder of the phone number. New employees must receive this information as part of their orientation.

A thorough implementation plan will include some form of documentation that employees have received information about the hotline, and that they understand it. Finally, the purpose of the hotline program should be mentioned in periodic "refresher" communications. If reminder messages are not included in the initial launch plan, the program is destined to dwindle and eventually die.

Sarbanes-Oxley requires audit committees to "establish procedures for the receipt, retention, and treatment of complaints received by the issuer regarding ques-

tionable accounting or auditing matters." This aspect of the law leads to several questions that board members should consider about the system for tracking and investigating allegations:

Will the audit committee members be automatically notified about allegations? To ensure that allegations regarding top executives reach the board, rather than being intercepted and covered up, hotline incident reports can be automatically routed to one or multiple audit committee members. A report dissemination routine should be set up with the hotline administrator so that the audit committee is notified of the activities mentioned in the Sarbanes-Oxley Act. These include insider trading, improper loans to executives, retaliation against whistleblowers, conflict of interest, and accounting irregularities.

Does the company have a case management system in place for tracking complaints? This system should include a database of the original reports, which enables the administrator (and potentially audit committee members) to review reports. This system should capture data about what the company did to investigate the allegation, as well as the final disposition of the investigation. Documentation should include the nature of any discipline or other corrective action taken as a result of the complaint. Should the company be sued, this documentation can be very helpful in a court of law.

We have entered an era in which directors are increasingly responsible for safeguarding investors. A hotline is just one of the many tools that directors have at their disposal to help shareholders regain confidence in corporate leadership. ■

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