

CONTINUOUS AUDITING: PROTECTING BRAND, PROFIT & CASH

Disbursement Assurance featuring *Profit-Protect* brand of Continuous Auditing as part of the Internal Control Framework

What if I told you that if you were a fortune 500 Company CFO or Controller that I could deliver an additional \$260M to your bottom line profits over a 3 year period? And what if I told you that the ROI for delivering that \$260M in additional profits would be over 5,000%? And what if I told you that with that you would also get SOX compliance, and reports with insights that would help you improve effectiveness and efficiency of operations that what would deliver further long term positive impacts to your bottom line. And what if I told you by engaging the practice that can deliver all these promises; that your relationships with your employees, front line revenue producers, whether internal or external, and key suppliers would all improve thus creating more retention based loyalty and opportunities for better pricing?

Does this sound too good to be true?

It's that good and is very true thanks to a model continuous auditing program that was created at a fortune 200 company 5 years ago. What made this unique, ground-breaking and dynamic was that this continuous auditing program featured proprietary forensic activities that were geared toward detecting errors and omissions, real time, in the area of disbursements. And with the development and implementation of this program spanning many operational finance areas, came quantifiable results.

And the surprising aspect is although the total impact of corrections over a three year period of \$260M was high, the percentage of defect against spend was approximately a quarter of a point (.0025); just low enough to fly under the radar screen of many a financial or Sox audit due to thresholds of materiality relative to revenue. But as we all know, especially in these troubled economic times, Cash is King. What Fortune 500 firm would thumb their noses at an infusion of \$75M a year? In fact in today's climate, a Fortune 500 firm would be fortunate if they could borrow 25% of \$75M, even if their balance sheet was strong and assets well allocated.

So how does continuous auditing produce these kinds of quantitative results? This paper will address this and give you some insight into the dynamic impact a continuous auditing program had on two fortune 200 companies. My proprietary version of continuous auditing, I call *Profit-Protect* produced some amazing results that I will share.

You will see that the uniqueness of this program was in how the continuous auditing techniques were designed and engaged, and that the focus of this program was not on SOX compliance, or traditional operational auditing relying on sampling with acceptable 1-4% error rates or on fraud detection. The model explained herein was geared at low percentage errors and omissions in a high volume transactional environment, which undoubtedly yielded high impact bottom line and cash flow related results, with SOX compliance as a by-product of a robust set of detective controls.

This paper will cover the need for a Continuous Auditing program for Fortune 1,000 firms, demonstrating the value proposition, the cost benefits and quantitative ROI possibilities, the unique methodology of this CA program, and the impressive results at two fortune 200 companies, with some examples of the types of defects this program detected.

Errors and Omissions can be just as damaging as Fraud

The recent realization that Bernie Madoff may have been running a Ponzi scheme and that up to \$50B in investment capital may all be gone once again brings attention to losses caused by Fraud. Let's face it, Fraud is headline grabbing because it's so often prolific, it can involve volumes of cash that are mind boggling, it's egregious, and it's clearly illegal.

The Association of Certified Fraud Examiners (ACFE) estimates 7% of corporate revenue is subject to fraud. Not surprisingly, much has been written and published in relation to fraud with increasing efforts focused on prevention and detection that include the auditing profession, ACFE, the Sarbanes-Oxley Act of 2002, and the proliferation of forensic accounting practices to name a few.

Fraud is perpetrated in many forms, including acts designed to funnel cash out of Procure to pay systems, illustrated recently when employees of the DC government created ghost vendors and co-signees in order to generate \$40M of fraudulent tax refund checks over an 8 year period. This act brought focus on an area already perceived to be of high risk. But fraud is not the only risk based culprit of Procure to Pay.

Whereas the news over the past 8-9 years has focused on a myriad of US Companies whom have had major financial restatements due to a lack of or breakdown in internal controls that allowed for fraud in its financial reporting, designed to benefit the firm; the less headline grabbing erosion to corporate profitability and credibility is more often related to errors and omissions.

And we are not just talking about errors and omissions that damage revenue recognition, which had been the case in the middle part of this decade impacting numerous public companies such as Fannie Mae and Freddie Mac well before their recent balance sheet meltdowns, but errors and omissions related to a company's disbursement or spend. It is the errors and omissions that impact company disbursements that can easily fly under the radar screen of thresholds of materiality recognized by external auditors yet are still seriously damaging to a firm's bottom line. So in this case we are talking about errors and omissions related to Procure-to-Pay and Hire-to-Retire activities.

Take Microsoft's recent Faux Pas in that it overpaid a portion of 1,400 of its laid off workers. The PR heat on the recovery was so intense that Microsoft decided to allow the ex-employees to keep the overpayments which exceeded \$1M in total. How often does this happen when it is not front page business news?

US company errors and omissions statistics are not readily measured, or publicly available. As stated, the ACFE put their estimate of Fraud at 7% in their 2007 annual report. That seems alarming when you apply that rate to any Fortune 1,000 company's earnings. But what about the rate of unintended acts that we call errors and omissions? Unless significant or material reporting levels are reached, the general public and investment community rarely learn about payment related errors. Besides, with the May '07 release of AS 5, auditors conducting Sarbanes-Oxley (SOX) assurance would focus mainly on controls that protect the integrity of a firm's financial reporting. So as long as a company is booking an unnecessary erroneous payment properly, auditors conducting a financial reporting/SOX engagement as opposed to an operational engagement would not be obligated to do more than to review impact against thresholds of materiality to determine extent of control deficiency. But the point isn't that disbursement based errors and omissions are publicly exposed; the point is that even in well controlled business environment, there exists an unknown or even sometimes a measurable tolerable error rate that is not always systematically addressed.

All too often the expenditure processes including Hire to Retire and Procure to Pay processes are not given the same attention and consideration that is provided to Order to Cash or Revenue recognition assurance activities. Because losses in the expenditure process are often addressed retroactively, are not easily measurable, are not necessarily recurring, and are downright embarrassing, they are not brought to the attention of the CFO, sometimes dismissed as rounding errors, or all too often considered as acceptable short term losses of conducting business, if they are even measured at all.

But the bottom line is that many US companies including public and Fortune 1000 companies have acceptable or unknown disbursement error rates that are too high. And when you are dealing with a multi-billion dollar enterprises, a rounding error of a quarter of a point can result in losses of millions. A Billion dollar firm with an error rate of $\frac{1}{4}$ of a point would potentially be bottom line impacted by \$2.5M. If a quarter of a point and \$2.5M per Billion still does not grab your attention, consider that \$2.5M in relation to an 8% Net Income margin of \$80M. That error of \$2.5M would represent 3.1% of that \$80M. That could be enough to impact per share earnings against analyst estimates.*

When you figure that the Fortune 1,000 all had operating revenues > \$1B in 2007, the marketing universe for prevention of a quarter point is rather considerable.

So where does this quarter point of error rate reside and why is it seemingly ignored?

The errors and omissions I am referring to, reside in the inner workings of financial operations, specifically, the areas of disbursements: Employee and Vendor Pay, also known as A/P and Payroll, or more end to end evolved processes such as Procure to Pay or Hire to Retire, which includes supporting administrative or finance operations such as utilities, lease management or real estate, tax, T&E reimbursements, corporate cards, commissions or compensation administration, HR benefits; operational finance or HR groups that produce a payroll check or vendor payment. In addition, complex processes that include varied or disparate systems, or ERP disconnected pay methods that include

wires-ACH-EFT-checks-ghost cards-corporate cards, open the door to mistakes as well as fraud.

Domino Effect of Errors and Omissions: High Impact to Cash Flow and Credibility

This is where it gets interesting because you would think that losses of this nature in and of themselves are damaging enough. Not quite. Low percentage errors such as these actually have a domino effect that also flies under the radar screens, but are silent corporate reputation killers.

The damage that is caused by Errors and Omissions is not limited to the erosion of profitability. Errors or delays in back office payment based processes have significant compounding long term negative impacts in unimaginable ways. Not only do these losses negatively impact cash flow, but they have an even broader impact to key relationships that can impact future revenue acquisition, internal productivity and efficiency, as well as the cost to conduct business.

Mistakes in payments to revenue producers, key suppliers and even G&A employees, erode their confidence in the firm, creating brand damage that will result in sales churn, poor sales production, reduced payment terms and credit lines, less than preferred pricing, increase in fraudulent invoices, increased employee churn, lower employee productivity, and slow the supply chain.

In other words, ensuring maximization of revenue opportunities should be no more important than the preservation of that very same revenue and cash flow from erroneous expenditures, as well as ensuring valid payments are made timely and in full. The impact is full circle when revenue producers are not paid accurately or timely.

Quantifying the Error Rate

So given the impact errors and omissions can have on a firm's ability to meet all its revenue objectives and the bottom line, the two questions that beg to be asked are the following: Why are Fortune 500 companies with seemingly evolved processes that include robust ERP systems, have error rates that are likely 1/4, to 1/2 a point? And why are these Fortune 500 companies not more focused on Disbursement Assurance and employing Six Sigma programs to protect the integrity of spend?

Here are some experiential reasons as to why errors and omissions exist at a minimum perceived rate of a 1/4 of a point.

- **Change:** Fortune 500 companies are Fortune 500 companies because they grow through M&A activity, so financial operational processes and the systems they employ are in constant flux. As mentioned earlier disparate systems may be in place, rules based IT systems are not consistent or lacking. Integration activities are incomplete.

- **Data Integrity** caused by a myriad of reasons. Most common are use of multiple ERP and or billing or payment systems. Also disconnects between IT and the business on what the data parameters should be, how it is delivered, and what upstream changes that could impact key downstream feeds and reports. This includes lack of business intelligence middleware that allows for precision in data requests. How data is stored, accessed, and communicated. Six Sigma focuses on process perfection, and may not include the garbage in garbage out theory caused by change and basic data integrity.
- **Lack of end to end ownership of the data chain** that will result in data integrity issues.
- **Manual Processes** that may include infrequent and or complicated undocumented offline processing or calculations coupled with redundant job responsibilities
- **Lack of consolidation and/or centralization** of payable process functions or payment methods (purchase card vs. voucher creation). This is beyond disparate ERP systems.
- **Investments** into **ERP** and support systems are not always as complete as they should be, due to **budgetary restrictions**. So for instance a Treasury module may be missing that defeats much of the purpose of automating the ERP to begin with.
- **Over Customization of ERP and support systems** implemented by businesses are all too often over customized, causing unintended consequences impacting rules based programming, especially when a change is required.
- **Non standard, unusual transactions** that by their nature are subject to error. Many companies have or allow for too many exceptions.

There are a number of reasons why Fortune 500 firms do not place requisite emphasis on rooting out this perceived and experienced ¼ of a point in errors that exist in employee and vendor pay.

- Many companies do not measure their true error rate in any form whether by payment type or by dollar remitted
- Because the error rate at or below ½ a point it is deemed acceptable
- There are not enough adequate resources available for quality control or disbursement assurance activities. And when companies look to reduce expenditures, these very same financial operations are often among the first casualties.
- Reliance on Profit Recovery firms to capture this low percentage of payment errors.

Here is the rub. Whereas most US firms expend the necessary resources to ensure maximization of revenue through rigorous controls, and continuous audit attention in the form of Revenue Assurance operations, there is not equal or even adequate attention given or preventative based defined approaches available, for the preservation of cash assets we call Disbursement Assurance.

Interestingly, as just pointed out, many US companies, as means of Disbursement Assurance rely on Recovery Audit firms such as **PRG Schultz**, or **Profit Technologies** to review expenditures once annually. Relying on this method for detection translates into

payments being recovered in arrears with 15-40% never being recoverable, not including the recovery value being eroded by contingency fees. But alas, this activity often only covers Accounts Payable related activities, and does not consider integrity of non contractual, non tax based, non credit bearing, or non duplicate based payments. For instance if a firm has over accrued expenses, let's say receipt accruals, over an extended period, will a recovery audit tap into that? Will it pick up system held rent payments due on the first of the month?

One other negative attribute of relying on a recovery audit; **the damage to the firm's reputation and credibility with their vendors and employees has already been done.**

A better or best practice would not only be to provide equal or greater emphasis to the area of disbursement assurance as is applied to revenue assurance, but that the disbursement assurance engagement or program be preventative in nature. It is through prevention of errors and omissions that the key relationships that impact cash flow, profitability, brand, productivity and reputation, be preserved and enhanced.

It's the age old adage of; "an ounce of prevention is worth a pound of cure." Better to prevent a disease then to deal with the symptoms once it occurs. So, since we are resorting to medical analogies, in this case enter our prescriptive preventative medicine, continuous auditing (CA), or better yet a proprietary brand that includes forensic accounting I call *Profit-Protect*.

What I discovered as I developed this program at two public companies starting in 2004, that Six Sigma level of Disbursement Assurance can be achieved utilizing a system of rigorous controls, which include continuous auditing (CA) coupled with forensic accounting, and control monitoring (CCM) designed to detect business and IT related irregularities resulting in corrections prior to payment. Thus cash was protected and key business relationships were measurably improved. To find out how, read on....

Three (3) year Case Study at two Fortune 150 companies

My proprietary version of Continuous Auditing (CA) that I call *Profit-Protect*, was not born out of a need to be Sarbanes-Oxley compliant, but a more aggressive need to reach six sigma like levels of excellence in payment processing. And because of the complexity of the organizational structure, with many upstream groups feeding AP and payroll with files for processing; this called for a program that did more than just prevent errors through a system of internal controls, but a process that included a means of rooting out errors and omissions that were plaguing a very successful telecom business.

Out of this desire to be best in class was born this program designed to detect and correct errors and omissions preferably before payment batch files reached the ERP, or transmitted via EFT or ACH to the bank or file to a check printing machine. *Profit-Protect* which was developed at firm A, consisting of a team of trained auditors who performed related Continuous Auditing (CA), featuring pre-packaged forensic accounting activities, and

Continuous Control Monitoring (CCM) that had a tremendous impact in protecting the firm's cash flow and profits. What's more our team detected items that would not have been paid on time or accurately on time, guaranteeing customer satisfaction. Ultimately this customized CA program not only improved the firm's internal control fabric and reduced the cost of Sarbanes-Oxley (SOX) compliance, but perhaps most significantly and uniquely, over a 4 year period, identified over \$300M in errors and omissions that resulted in successful accurate payment or accounting (GL) corrections.

Profit-Protect Begins and Expands

How did this start and evolve? In 2002 I utilized CA to combat the low but impactful error rate in the firm's commission operations. These errors were mostly the result of ever changing compensatory rules, consolidating manual practices, disparate and inconsistent IT capabilities, hundreds of thousands of various types of monthly transactions, with thousands of employees and partners earning credits that could not be easily matched to the phone activation record or phone set purchase. When Sarbanes-Oxley went into effect in '03 many of these CA activities were documented as key detective controls that ensured payment and accrual validity to a very large annual disbursement total. The program was such a success that the firm's VP of Shared Services, who was a big proponent of leveraged core competencies, decided that this CA program be expanded to all Shared Service operations.

So starting in the fall of 2004, ***Profit-Protect*** was rolled out in Vendor Services (AP, card service, T&E, and vendor maintenance), and in Employee Services (HR Benefits, Payroll, Employee Transactions) using a traditional audit approach of conducting risk assessments to determine the areas of risk but also integrating a unique approach to disbursements based on the **SAS31 Financial Statement Assertion** framework. By January 2005, the program was 70% executable and required only additional auditing resources to be whole.

Overall the results to say the least were compelling. Over from '05 through 2007, a period of 36 months, my ***Profit-Protect*** team detected and corrected over \$275M in potential payment errors, an estimated two and a quarter point (.0025) of all spend managed. 90% of the \$275M corrected was done so prior to disbursement, thus in a vast majority of cases was averting overpayments. A minority of corrections either increased payments or discovered payments that would be made late or not at all. Although some of the findings can be attributed to merger related activities, most of the types of errors and omissions corrected were not what one would expect to find in highly automated and evolved processes. Yet in many companies some of these types of errors could go completely undetected while some could be captured months later when Internal Audit or a Recovery Audit Firm conducts its procedures.

Many of these errors could possibly avoid detection because they in all likelihood would fall outside the 90% confidence level and 5-8% margin of error utilized in standard sample sizes taken by Internal Audit. Also, since an unknown percentage of these, (estimated at .0015%, explained later in this paper) are corrected by the time External, Internal or a

Recovery Audit firm conducts their samples, they are less likely to raise the alert level. Remember though, the purpose of this CA program is to prevent the errors and omissions.

So one of the many elements that separate my brand of CA, ***Profit-Protect*** from traditional Internal Audit is the unique criteria based methodology (mentioned earlier in relation to the 5 Financial Statement Assertions of SAS 31) used to analyze pull, processes and analyze data, in that it's designed to capture the 2-3 tenths of a point in error rate that plagues most companies.

The results though are far reaching in that this program acted as a deterrent and a source of detection for Fraud and provided an additional layer of SOX compliance. For instance the CA ***Profit-Protect*** program identified a vast number of T&E fraudulent requests for reimbursement that while not significant from a materiality stand point, was costing the company tens of thousands monthly. We also detected issues with SoD, both systematic and manual, IT data integrity in Electronic Application Interfaces (EAI), other system related issues believed to have been caused by over customization of the software, system access rights and privilege issues, and process inefficiencies, among other matters. Overall, SOX compliance costs were reduced and the amount of time required by operational personnel was minimized, since deep substantive testing and other key resources were maintained by the CA team.

But again, to continue emphasizing the untapped frontier (William Shattner should narrate), the unique opportunity is the detecting and partnering with finance, business, HR and IT operations to correct errors and omissions prior to payment. The tracking and quantification of those numbers alone (\$275M) provided an incredible ROI for our program costs that was mindboggling.

The following summarizes the total value proposition in outline form of a Continuous Auditing or ***Profit-Protect*** program as a cornerstone for Disbursement Assurance in a Shared Service or Finance Ops environment that include traditional AP and Payroll functions, demonstrating the value of going after low percentage error rates in a high volume business, and the value it has on the company's brand.

The Value Proposition: Making the Case for Disbursement Assurance via the *Profit-Protect* (CA) Route

Profit-Protect delivers in four ways key ways.

- I. Maximization of Profitability
- II. Increased Cash Flow
- III. Brand Protection
- IV. Sarbanes-Oxley Compliance at a dramatically reduced cost

How this program delivers on these objectives.

I. Maximization of Profitability

A. The True Cost of Errors & Omissions

Companies that boast operational disbursement accuracy rates of 99.9% (Three nines of accuracy, or 1 tolerable error per 1,000) have a $1/10^{\text{th}}$ of a point of error. How well Fortune 500 companies are at measuring their true disbursement error rates, for instance, can be debated. However, let us first look at the value of the $1/10^{\text{th}}$ of a point on say \$10 Billion in spend. That's \$10 million! Say that again, \$10 million.

The $1/10^{\text{th}}$ of a point in relation to total spend, may represent a rounding error to some, but in terms of profitability and cold hard cash, a CFO trying to meet a hurdle rate, would not consider that lump sum to be insignificant. And certainly if the effort to protect \$10M would cost less in effort

B. Error and Omission Incidence and Relativity: Justifying , at minimum, the $\frac{1}{4}$ pt of Perceived Error

Now that we have emphasized the profitable impact of a 10^{th} of a point, imagine the impact of one that is double or triple that size. But how do we know what it is, and that it's likely a quarter point or more when there are no released measurements. And when fortune 1000 firms do measure their disbursement error rates, are they including all spend such as payroll, utility, real property, taxes, customer refunds, commissions and accrual accounting? And are these accuracy rates pre-payment or post payment?

Chris McKee, principal of Profit Technologies, a recovery firm in Houston Texas, told me in 2007 that the recovery business model is based on an expected capture of $1/10^{\text{th}}$ of a point on A/P and Tax only. This was confirmed by an ex auditor of PRG-Schultz, long considered one of the preeminent Audit Recovery firms. Since most recovery audit engagements take place 3-12 months after the close period and are conducted a year at a time, the experiential error rate of $1/10^{\text{th}}$ of a point on the A/P spend would support the primary error rate would have to be greater. Most companies provide recovery firms lists of errors they are aware of and have either tried to collect or are in the process of collecting. And what about errors and omissions associated with non A/P payment functions that we just discussed?

At these two Fortune 150 firms, my team was finding primary error rates ranging from $\frac{1}{4}$ of a point to $\frac{1}{3}$ of a point. At Firm A, in 2005 the detection rate against spend was .3%. After 1 year of having *Profit-Protect* at Firm A with management enacting policy and control changes to prevent or reduce reoccurrences of mistakes, we saw the detection rate slip to .17%.

At Firm B in 2006, we saw an operational error rate of about .25% ($\frac{1}{4}$ point) before consolidation activities took place.

Hence based on experiential results of *Profit-Protect* and the detection rates experienced in the Profit Recovery industry, the .25% (¼ point) primary error rate can be easily assumed.

And with a ¼ pt error rate, a fortune 500 company spending \$10 billion would have an impact of \$25M. **\$25M!!!!**

B. Front Line Sales Assurance

Continuous Auditing ensures profitability by increasing revenue and protecting profits. How does a Disbursement Assurance program increase revenue? It does so when it assures payments to revenue producers are dead on target. It not only builds retention of the sales force, when reps are satisfied with how they compensated for the sales they derive, but it can have a positive impact on productivity as well when you consider more hours will be spent on selling activities because reps are not focused on statement accuracy and payment errors. Once this credibility is established and maintained, it can have a striking positive impact on sales productivity and retention, thus driving revenue. At two major companies, this was quantitatively proven when after respective commission system implementations with significant enhancements that included greater transparency and ease of calculation, were complete, the rate of appeals decreased dramatically and productivity increased, as both firms saw a significant measured increase in activation/order activity.

These same dynamics also impact outside sales reps or authorized representatives or associates who produce company revenue. The owners of these outside small to mid size companies can be made to be satisfied with their compensation based on their selling activities resulting in increased selling time resulting in greater revenue; or they could be holding the firm in contempt for poor pay practices, hard to read payment statements, and lack of customer response, which results in lower productivity, smaller revenues, churn, and even lawsuits against the firm.

So to recap, increasing accuracy in sales producer payments and statements can translate into growth in sales, as well as long term recurring revenue streams.

Contrast this to Sales employees whom look at the company as being a villain by not paying the sales producer their rightful commission. These folks spend countless hours going over statements and filing appeals. And their retention becomes tentative. How productive is that?

C. Employees

Employees who experience difficulties with their pay or benefits in respect to on boarding or through other qualifying events such as time and labor payment rates and eligible hours by pay period, overtime pay, bonuses, deductions, change in benefits, for instance during the employee lifecycle, are more apt to shorten that lifecycle. The opportunity costs are similar to revenue producers except the impact is on G&A productivity as opposed to front line revenue. But depending on severity, loss of key employees can affect financially

impacting areas such as compliance. Let us not forget the lost opportunity costs in replacing competent employees.

The bottom line: When valued employees, and key revenue producers (sales) in-particular are not paid timely or accurately, their confidence in their company begins to diminish, productivity suffers, and more often than not this becomes an impetus for them to leave, and when they do, the talent is now often headed toward the competition. So not only is there an opportunity cost to replace the stellar sales producers associated with no productivity, recruiting, interviewing, training, and ramping, their efforts are now feeding a competitor. Ouch!

D. Suppliers

Suppliers who are paid late or inaccurately are likely to raise their unit costs, slow down or limit supply of good and services, reduce terms, eliminate discount opportunities, and may test billing capabilities. Some Suppliers when they recognize customers do not scrutinize bills, may increase unit pricing schedule or not apply eligible volume discounts to their billing. Conversely if the company is remitting late, the firm's Credit Rating can be adversely affected, thus impacting borrowing capabilities and adversely affecting the firm's access to preferred rates for funding.

II. Increase Cash Flow

The current economic crisis emphasizes the age old business adage all too well, Cash is still King. And the most unique value aspect of Continuous Auditing is that continuous audits are run live and include continuous control monitoring over key transactional junctures designed to **prevent** erroneous or invalid payments from ever being released.

The ability to halt an erroneous payment or correct a mistake before payment is generated is huge. By averting an overpayment, not only is the embarrassment of having to approach the employee or vendor been removed, the concern that the funds could even be recovered at all has been eliminated, as the cash is still in the bank, thus available to fund other ventures.

III. Brand Protection

The Brand or reputation of the firm can be impacted in many ways everyday. But certainly errors and omissions erode the confidence of all those impacted and word travels fast when incompetence is perceived in an organization's ability to conduct basic business transactions. Front page business news headlining a lack of controls or corporate fraud can damage a brand. For instance scandals in which corporate expense cards and gift cards were inappropriately used by C-level execs over the past few years has brought adverse publicity to the company and has had short term negative impact on stock prices. Beyond preventative controls there are some forensic activities to monitor this type of spending.

IV. Sarbanes-Oxley Compliance

Since SOX is about controls, and detective controls of this nature are designed to be more comprehensive, stamping out the 1-3 tenths of a point in payment error rate, certainly SOX compliance is enhanced. With Continuous Auditing acting as a deterrent and detection for fraud and errors and omissions, this certainly cannot be described as a tail wagging the dog act. Here, SOX compliance is a by product of having a model set of detective controls in place. But there are even more residual benefits to this program. Since the auditors responsible for the Continuous Auditing continuously engage in detective audits, not only do they more than meet reasonableness for SOX standards, because of the rigorous nature of audit execution, but they are in a perfect position to provide documented support regarding the effectiveness of the internal controls they in effect are substantively testing. Having the CA team provide this support in relation to internal control effectiveness makes operational personnel more productive, documentations more uniform and easy, and makes the work papers readily available on demand, thus saving the business time scrambling to put together testing support.

Overall the value proposition of a continuous audit program geared toward protecting the spend of a fortune 600 company is clear. It protects profitability, cash flow, and preserves key business and employee relationships that further impact profitability, from both ends.

Continuous Auditing Framework

The following is what makes our version of CA, *Profit-Protect*, unique, and how the program is designed to detect low percentage occurrences in a high volume transaction environment.

There are a number of factors that makes *Continuous Auditing* a unique program.

1. It's continuous

Audits are developed based on risk assessments and the frequency of transactions. Risk points are observed, audit objectives created, programs written, and executed based on transaction frequency and run mostly prior to payment activities in order to provide enough time to correct a mistake.

2. Features use of forensic accounting

Whereas many service bureaus use forensics to detect and prove fraud, Continuous Auditing applies the same principles of accounting, auditing and investigation that provides the necessary dispute resolution. Basically there is sufficient evidence collected in which to prove, for instance, a debit to an expense account as opposed to an accrual, a misapplied credit, a corrupt data upload, an improper benefit deduction, erroneous bonus and advance calculations, debit-credit transpositions, holds on credit vouchers, invalid tax assessments.

3. Comprehensive use of Data

Instead of using a statistical sample based approach which would have to be widened pretty drastically in order to create a 99% confidence level and a (+) (-) 4% margin of error, the idea here is to pull all the data and focus on pre-determined risk based variables that will result in a 100% capture of an error. For instance in A/P, all credits entered into the ERP would be compared to payments made to their respective vendors after the credit was posted. This would capture both credits on vendor pay sites (based on varying vendor payment terms, methods of payment and location) that were inactive, unapplied or terminated. This would allow credits on inactive or termed sites to be moved or applied to active ones, thus reducing cash payment to vendors for open vouchers that exceed credit amounts.

4. Self Reliance and Independent Access to Data

Whereas most internal audit departments rely on AP, Payroll or IT to provide requested data, Continuous Auditing relies on unrestricted, uninterrupted access to data either by direct query into the ERP data tables, front end business intelligent report writer, or daily data dumps into data warehouses that can be subject to queries written by trained continuous auditors. In CA, time is critical, so there is no time to go back and forth with business or IT management on data requests or disparities. Data with all requisite fields must be available for the analytics and filters that CA auditors have crafted.

5. Leveraging SOX Compliance

The routine collection activities of support such as invoicing, PO's, T&E approvals, Interfaces (EAI) reports, Upload approvals, ERP access reports, can be used to more rigorously test controls, and can be provided to attest to a control's operating effectiveness or weakness. Basically this is heavy duty substantive testing that tests a myriad of upstream controls. By mapping the results to controls or lack thereof, management can begin to mitigate by making the necessary changes based on cost effectiveness. In some cases it may be more cost effective to allow proven CA detective techniques capture these low percentage, but costly errors.

Continuous Auditing Delivery

The ***Profit-Protect***, continuous auditing model is geared toward pre-emptive detective activities covering all key business processes. These normally can be grouped in the categories of **Order to Cash, Hire to Retire and Procure to Pay** and includes all IT related support applications as well as their supporting networks and systems platforms. The diagram below provides an over view of the areas of coverage, the continuous auditing methodology with procedures that we utilized to make this program successful. The program I employed at the two firms, was never directly tested on Order to Cash activities, although we had some commission based findings that led to billing changes that we were unable quantify. Examples of some of the types of errors and omissions we encountered are enclosed below.

At both Fortune 150 firms, ***Profit-Protect*** was successful in identifying the low percentage transactional error rate and detecting 90% of those in time to a pre-payment correction, because we applied traditional and forensic auditing techniques to the overall business process. In addition we had unrestricted access to data enabling us to be self sufficient. We also had terrific cooperation from the entire Shared Service organization from associate to operating director in order to get expeditious responses to issues of concern, so that we were able to prevent errors and omissions as opposed to recovering on them.

Value to Internal Control fabric and to Operational Effectiveness and Efficiency

Having everyone appreciate and embrace the program at both companies took some time in that we were identifying errors that could be attributed to associates and managers and sometimes represented a breach in effectiveness of operating controls, but over time the value proposition became more and more clear as was the fact that we were working together to identify the defect prior to disbursement. Thus their business error rate was not reflected in what our CA group reported, but in what their true transactional output was, after their corrections based on our findings.

So their true error rate became a measurement of errors detected after payments were made brought to management's attention internally, by our group or most notably in cases of short payments, by those payees adversely affected. Our team did maintain those numbers demonstrating the overwhelming success of the program. Managers and their teams started embracing our auditors and program more when our Vice President of Shared Services recognized the business groups who were lowering their primary and secondary error rates.

The Payroll group at Company B in particular became a great example of the value of this program and how we won over the support of the Payroll Director. Errors spiked when after a merger personnel with limited training began using a process and ERP software they were unfamiliar with. The "adopt and go" method resulted in a dramatic increase in errors and omissions that fortunately the CA team was able to detect a large proportion of in a timely basis. But with every type of error we detected, the Payroll group reacted by implementing an operational change or control designed to prevent re-occurrence. The

result was a dramatic reduction in the number of defects and dollars impacted over a 6 month period. This became a source of pride for the Payroll department as we reported monthly on the defect rate by sub operation.

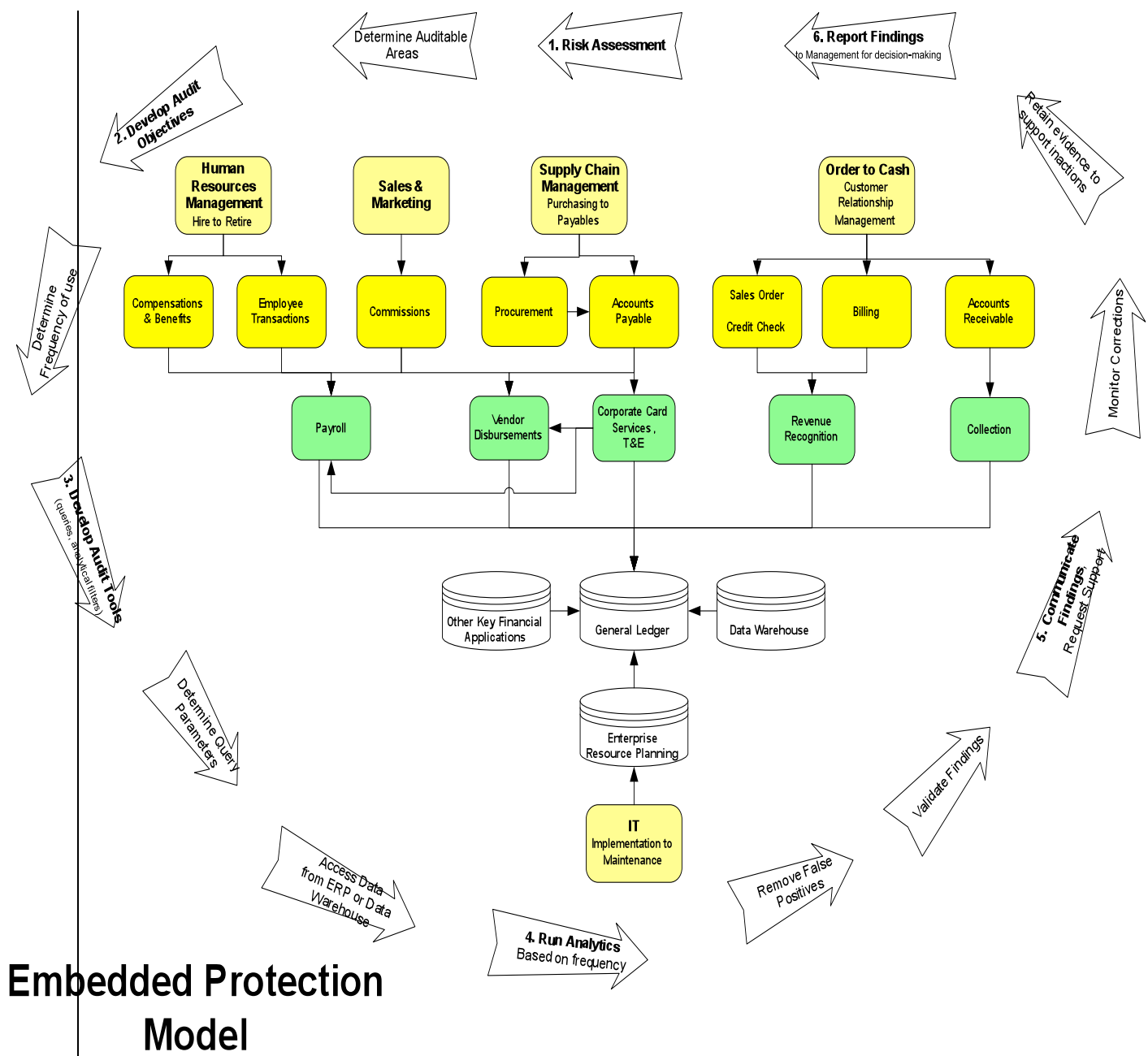
Over time we trained key Payroll personnel on many of our audit procedures making them self sufficient. This enabled us to focus on other areas of risk.

The other positive by-product to this program was that the external auditors did not find weaknesses in control design or effectiveness in part because CA was part of the control framework. The detective measures that we either executed on a regular basis or turned over to operations to run were part of a greater control framework that our external auditors found to be impressive. Audit teams from both Deloitte and KPMG both expressed to me and Shared Service Vice President, the uniqueness of our program in comparison to their other engagements.

Needless to say with a program as robust as this, all operational audits conducted by Corporate Audit Services during our tenure were rated in the 90th percentile as “effective with improvement opportunities”. Two departmental audits were deemed to be “marginally effective,” prior to the implementation of our CA program. Clearly the protective aspects of this program are far reaching and have a positive cyclical impact.

Embedded Detection Brand
Continuous Auditing Architecture
Delivery Model

On the next page, the chart that outlines the *Profit-Protect* steps against the potential areas of coverage.



Examples of Types of Errors and Omissions Detected

To many these could be eye openers. The following are some examples of the opportunity that exists by deploying a CA program using the ***Profit-Protect*** methodology. These are examples of some of the types of corrections by Operation that we encountered that a Continuous Audit can address. This is not an exhaustive list by any stretch and we maintained data by process, sub process, by type, by topic, by issue, by group, impact, root cause, underlying control, and by detection method employed.

GL

1. Receipt Accrual overstatement
2. Wire payments not updated in GL
3. Bank Debits not updated in GL
4. failure to debit accrual liability when payment issued

Procure to Pay

1. Vendor Master duplicates
2. Purchase Orders set to an unintended vendor
3. Contract Pricing and volume discounts not adhered to
4. Wire Transfers of existing vouchers entered as new vouchers
5. Voucher record of offline Wire not updated, which could result in duplicate ACH or check
6. Voucher record of wire set to pay as ACH or check, which could result in duplicate payment.
7. Vouchers on Receipt Hold erroneously which could delay payment based on due date.
8. Obsolete Customer Refund files continue to reside in ERP
9. External (Rent, Commissions, Tax, Customer Refund) Source EAI or EDI files contain duplicates or erroneous calculations
10. Credit memos misapplied, and not applied to outgoing payments to Vendors
11. Pay group / pay method mismatch derived from vendor location resulted in pay cycle not picking up vouchers for payment.
12. Check Request set up as non ERP wire payment
13. Vouchers matched timely in order to take advantage of discounts

Hire to Retire

1. Annual Pay rate entered in a hourly field
2. Retail T&L interface not complete due to paygroup set up error
3. FLSA Standby Rate set to pay at 100% instead of 10%
4. Regular hours set to pay terminated employees because of ERP pay line error.

5. Paylines from previous or future pay periods loaded to current.
6. Overtime payment violations
7. Regular Hours > 80 for 2 week period
8. Employee classification for OT inaccurate
9. Non California employees not eligible for double time are able to receive it.
10. Quarterly Bonus set to pay eligible terminated population at 100% instead of 20%
11. Duplicate Severance Payments Issued
12. Severance settlement calculation is inaccurate
13. Incorrect STD payments set up
14. STD payments coincide with regular pay for employees who have returned to work
15. Sortation of upload file causes transposition of 200 employee payments
16. Annual Bonus loaded but not approved for disbursement

Taxes and Accruals

1. Accrual for tax payments not offset at time of debit or payment
2. Sales and use tax calculation flawed
3. Ineligible sales and use tax set to pay
3. over accruals for sales and use tax
4. Government assessments of underpaid sales and use tax invalid

External Group submissions to A/P (Commissions, Benefits, Customer Care, Engineering, Marketing)

1. Advance recovery set as credit instead of debit
2. Duplicate pay file submitted, two months later
3. Duplicate adhoc submissions from same or different approved sources
4. Duplicate in pay file
5. Additional zero turns \$100 refund to \$1,000
6. Interface error holds file for payment
7. Format used to pay sales employees, incorrect
8. Payment requests are invalid as they violate contractual rules
9. Upload files incomplete
10. Promotions or Comp policy written in a contradictory or unclear manner
11. Contradictions in communications sent to field offices vs. administratively
12. Residual Compensation payment calculation errors
13. Data used to pay residuals is incomplete or duplicated
14. Lack of support for Marketing Development Fund payments

Note this is not an exhaustive list, and some of these issues were never repeated. Fortunately due to the CA team, 90% of these were detected, verified by operations and corrected prior to payment. In some cases it could be argued that the CA team reported these issues before operational activities would have detected these conditions themselves. Regardless, the mistakes had been made and resided in the ERP or supporting schedules that were set to load to ERP, which would have resulted in a great deal of additional work truing up those impacted and recovering overpaid funds.

Internal Control Clarification

In regard to controls, both firms had reasonable business and IT controls in place that passed SOX and Operational Audit testing. Keep in mind when you look at this list some of the items seem surprising, incomprehensible, silly and perhaps even egregious. But they still represent about a ¼ point of the overall spend and in most cases an even lower % against company revenues, thus not making these material from an internal control impacting financial reporting perspective.

In other words, the business and IT controls were reasonable and preventing fraud and errors from occurring that would constitute a threshold of materiality. But given the overall volume, the dollars are certainly worth protecting, not to mention the other unintended consequences discussed earlier.

Value Proposition Summary

This concept is from an objective perspective is an application of TQM or QC practices to a Disbursement world. But ***Profit-Protect*** utilizes a unique forensic audit approach to payment outcomes. As emphasized earlier, SOX compliance is a byproduct of a good CA program, not the basis of it. CA when utilized in a typical Shared Service operation goes beyond reasonable measures, delivering blanket protection against small percentage of errors for firms that have large volume of transactions, Fortune 1,000 level revenues and expenditures and may include some of the following: decentralized operations, outsourced, varied IT and ERP systems, and complicated and unusual non recurring transactions. The CA program I developed was tied using Balanced Scorecard methodology to the corporate strategic measures thus ensuring the cash flow, revenue generating, service model relationship protection measures described above in the value proposition.

Companies with justifiable levels of spending (\$1B or more at minimum) can easily fund this program with a measurable ROI off the prevented errors that preserve cash flow. In economic times like these, cash preservation alone becomes a compelling reason to begin a Continuous Audit practice focused on spending based operations.

While many business leaders complain about the cost of SOX compliance, the two firm's I supported, compliance costs for their Shared Services were supported by an outrageous ROI multiple of 64. The ROI is so overwhelmingly compelling I wonder why more companies have not implemented a similar model that is not focused merely to fraud.

Thus the overall importance of this program is that not only is CA capable of ferreting out fraud, which our program did. But we looked at results that were indeed more prolific from a total dollar perspective. ***Profit-Protect***, was very instrumental in protecting the business brand, reputation, credibility, cash flow, as well as the external and internal business relationships by detecting errors and omissions proactively. In addition, the control environment and overall corporate culture was dramatically enhanced as these proactive detective activities acted as a deterrent to fraud, and most importantly an impetus for management to improve operational processes and performance as SOX testing time and costs are reduced.

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