

Effective Compliance Verification: Optimizing Compliance with Access to Data and Documents



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Abstract

In today's business and regulatory climate, companies are required to verify compliance for financial audits by CPAs, due diligence requests from capital providers, demands from regulators and multiple contractual requirements. While most companies have effective data based systems to manage their operational and financial data, few have an effective system to manage document-based compliance obligations. This results in higher costs and risks to both the company and its executives and directors.

This white paper concludes that incremental changes to a company's business processes can reduce compliance costs by as much as 44%--while they also reduce overall compliance risk. It first identifies six distinct steps required today for almost every company to verify compliance for document-intensive processes: 1) capture documents, 2) organize documents, 3) extract data, 4) verify data, 5) analyze data and documents, and 6) act. Second, the paper demonstrates how companies can measure progress in implementing an effective compliance verification system using six building blocks. The greatest improvements are achieved by aligning document and data management practices for subset of corporate information that is high risk/high value.

1. The Current Situation

Lack of Resources and Flood of Unstructured Data

Companies are facing increased regulatory demands to provide transparency to verify compliance and an ever expanding volume of information to manage, but have fewer resources. Mergers and acquisitions, bankruptcies, layoffs and slashed professional services budgets have disrupted company's strategies for managing their high risk, high value corporate information.

Compounding the problem is the explosion of emails as the primary entry point of high risk/high value corporate documents. Gone is the centralized mail room imposing order on important documents as they arrived in the company. Thousands of critical corporate records are sitting in email servers as attachments. PDFs in shared drives have taken the place of previously structured records management processes developed in the paper era. The net result is that critical corporate documents remain unstructured with no transparency, audit or other controls.

Employees are feeling the pain. In a 2008 Workplace productivity Survey commissioned by LexisNexis, a majority of employees in the legal and professional fields are feeling close to the "breaking point" in handling information flows.¹ In another study, 58% of respondents reported spending more than 25% of their time reviewing irrelevant information as part of their search/locate activities.²

This has resulted in a loss of competitiveness as critical corporate information is trapped in these documents and greater liability risks for companies and their executives and directors. While companies face multiple compliance obligations, they are reluctant to invest in any solution that does not also increase efficiency and generate business intelligence for the "C Suite." Any solution that doesn't provide these multiple benefits is unlikely to generate sufficient ROI for funding in today's environment.

Repeated Demands to Verify Critical Corporate Records

Companies respond to more and more demands each year to deliver their most important corporate data and documents. These documents include leases, customer contracts, equity documents, loan documents, key employee agreements, intellectual property documents, and others. These documents are spread across the enterprise and in the offices of attorneys, consultants and other advisors.

Requests for these documents come via:

- **Financial audits**, which require companies to deliver volumes of documents organized by the "prepared by client" list.

¹ Lexis Nexis (2008). *Lexis Nexis Workplace Productivity Survey*. Retrieved from www.lexisnexis.com/literature/pdf/Workplace_Productivity_Survey_Results.

² AIIM International (2008). *AIIM Findability Study*, from *Intelligence Quarterly*, Q2 2008.

- **Due Diligence** requests made by attorneys, investment bankers, and auditors, each with their own naming convention.
- **Regulatory Filings** that require companies to review and organize critical documents to match up with the regulatory naming conventions.
- **Contractual Compliance** mandates that require extensive reviews of multiple contracts to verify compliance with contractual obligations.

Consequences of Failure

What are the consequences of failing to satisfy these demands for corporate records? The penalties are significant:

- **Stock Price Decline.** Studies show that missing an SEC deadline by even one day results in a 2% reduction in the stock price. Companies that restate financial statements have devastating declines in their stock price.
- **Loss of Access to Capital.** With the volatility in capital markets and nervous investors, failure to respond timely and accurately to due diligence can kill a deal, depriving the company of needed capital or acquisitions.
- **Expensive Litigation.** Failure to comply with contractual obligations can lead to litigation for breach or preclude enforcement as rights are waived by inaction.
- **Regulatory Enforcement.** Failure to properly report required information can lead to regulatory investigations and enforcement actions.
- **Personal Liability.** Officers and directors face personal liability under regulatory requirements from the SEC, FTC, and other agencies.

In light of these potential consequences, the companies who can respond quickly and accurately by locating, identifying, and acting on critical documents have the competitive edge.

2. Compliance Verification Process

In responding to any of these requests to verify compliance, companies typically follow a similar six step process. Despite the importance, repetitiveness and costs of this process, few companies have automated or even optimized it.

Instead, most companies allow vast amounts of unstructured data to accumulate and then use expensive labor to respond at the last minute, increasing costs and risks. Few systems take the critical step, linking source documents and data.

The six steps of the compliance verification process typically include:

- 1. Capture Documents.** The most efficient methods capture documents at the time of creation and identify their compliance purposes. Without a systematic, auditable process, companies typically send out an email to all the potential people who might know where it is, including expensive attorneys.
- 2. Organize Documents.** Organizing documents, once the full set is captured, often occurs manually with expensive labor using the request list provided by the demanding party. The valuable time spent imposing this organizational structure on the documents is seldom retained by the company, so the same expensive process is repeated for the next request.
- 3. Extract Data from Documents.** After documents are collected and organized, important business and legal information must be extracted. Many companies repeatedly perform this process using a paper copy of the document and manually pulling data responsive to each request. Without a systematic capture process, the previously extracted data becomes inaccurate and this repetitive and error prone process creates significant risk for the company.
- 4. Verify Data and Documents.** Reviewers, who tend to be expensive auditors and attorneys, next verify that the document supports the extracted data. Also a manual process, the verification step also lacks audit controls. Reports created for verification purposes are not retained and the value of this expensive exercise is rarely captured for future use.
- 5. Analyze.** Trusted advisors and senior executives analyze data to make critical business and legal decisions, and accurately complete required disclosure and reporting documents. As these decisions are only as good as the data supporting them, any flaws in the first four phases of the process impairs the quality of the analysis.
- 6. Act.** Based on this analysis, company executives and their trusted advisors must file disclosure documents, enforce legal rights, defend lawsuits, negotiate deals and make critical business decisions. Clearly, companies acting without accurate and verified data linked to source documents that have been properly analyzed are at significant risk to suffer the consequences described above.

3. Measuring Effectiveness of Compliance Verification

A company's ability to timely, accurately and cost effectively respond to the multiple demands for verified corporate data and documents is directly impacted by the quality of its systems and processes. As companies implement each building block for an effective compliance verification process, they reduce risks and costs.



The return on investment (“ROI”) is significant as the building blocks transform ad hoc processes into an effective compliance verification system. Unlike typical enterprise wide risk management and compliance software solutions requiring long implementation cycles and significant expense before any ROI is possible, with a Software as a Service model and the “building block” approach, incremental ROI can be immediate and increase as more building blocks are added. When a company has implemented all six of these building blocks it will have a “Compliance Verification System” to replace its existing ad hoc process.

Paper to Digital: The Foundation

Companies maintaining paper based compliance systems face significant costs and risks. When analyzing the costs of paper versus digital, there are two potential sources of savings: 1) the operating costs of using paper and 2) the cost of a paper-based compliance verification process.

Operating Costs: According to a report from Coopers & Lybrand (now PricewaterhouseCoopers), in today's typical organization:

- 90% of paper documents used in an office each day are merely shuffled.
- The average document gets copied 19 times.
- 7.5% of all documents get lost, 3% of the remainder get mis-filed.
- Professionals spend 5-15% of their time reading information, and up to 50% of their time looking for it.

Add to this the cost of filing cabinets, rent, office supplies for printing and copying and the labor for finding, copying and distributing paper records and the costs add up.

Risks of Paper: Companies face significant risks with paper based compliance systems including:

- **Inadequate Disaster Recovery.** Many companies have no contingency plan if there is a fire or other natural disaster. According to a Gartner study, 2 out of 5 businesses that experience a major data or records loss due to a natural disaster go out of business within 5 years.

- **Decisions Made on Bad Data.** Without immediate access to accurate information, executive decision makers risk making costly mistakes.
- **Lack of Audit Trail.** With paper records, there is no way to provide an audit trail of who saw what.
- **Parallel File Systems.** Companies with distributed operations need to maintain their records locally for operations and centrally for compliance.
- **Valuable Corporate Data Trapped in Paper.** A company's most valuable information is locked inside its contracts. Leaving this data in paper inside file cabinets deprives executives of a valuable asset, impairing corporate competitiveness.

"I always call the attorney to verify that the version I got from the share drive is the most current."

- Administrator of PE Fund

Digital: At the foundation of any effective compliance verification system is digital records. With systematic scanning of paper documents into PDFs, a company can realize substantial benefits over paper based compliance processes. Costs of storing electronic documents are a fraction of paper filing cabinets. Labor costs are reduced, risks are eliminated and large improvements in efficiency are possible. At the heart of an effective digital records system is consistent and comprehensive capture from both paper and email records and other electronic document deliveries, such as closing binders of transactions delivered on discs. Without comprehensive capture, the compliance repository will be inaccurate, creating material risks of non-compliance.

Comprehensive capture, while critical, is difficult to implement for several reasons:

- **People Like Paper.** Many knowledge workers and professionals are more productive working with paper documents rather than using only a computer. To permit the productive use of paper without compromising compliance requires that the capture system verify that any paper document in use is a copy from the compliance repository. Having a "watermark" on each paper document instantly verifies that the original has been "captured," making enforcement of a comprehensive capture program auditable.
- **Documents are "Stuck" in Email.** The use of email to deliver important documents creates significant problems for any compliance verification program. These documents must be comprehensively captured as well as the paper. If an individual who receives an email attachment can merely forward it by email to the repository, this provides the least burdensome method to capture documents and ensure adoption.
- **Lack of Measure for Timely Capture.** Timely capture of documents is essential for an effective compliance verification program. However, without an auditable method to measure the date a contract or document is effective versus when it is filed in the compliance repository, there is no mechanism to ensure timely capture. The ability to generate reports

showing the “time gap” between the effective date and the submission date—by individual, department or other criteria—creates accountability.

To reduce compliance costs by shifting from paper to digital—and to realize the associated benefits—requires a comprehensive method to capture relevant documents from paper or electronic format into a single compliance repository. The system must be able to verify compliance with watermarks and user reports to audit and enforce the policy.

Shared Drive versus Secured Repository or Vault

While moving from paper to digital creates the condition for improvements in the compliance verification process, storing digital documents in share drives on network servers lack critical functionality needed for an effective solution.

Here are a few of the problems companies face using share drives as the repository to verify compliance involving critical company documents:

- **Documents are Mis-filed.** Share drives have a single filing structure with folders, multiple levels of subfolders and only one navigation path to find a document. Unless every user consciously follows the classification system and naming conventions, this results in inconsistency, inefficiency, and lost records. Users must open each folder to find a record. In fact, a 2005 study by the Department of the Navy showed that only 12.5% of documents were classified with exact accuracy at least 75% of the time.³
- **No Controls or Process.** Share drives have no audit controls or standard process to determine who can upload, delete or modify the records. This results in lack of confidence that the shared drive is an authoritative source of legal contracts and other documents. A lack of controls to prevent back dating and deletion of critical files also undermines trust, because this can threaten the entire compliance program.
- **No Ability to Sort by Attributes.** Finding a particular document or set of documents with a common attribute is very difficult in a shared drive. For instance, finding all office leases with an expiration date in the 4th quarter of 2011 for the state of California would require opening each folder and document to isolate three attributes, a tedious and expensive process.

Companies using shared drives to store high value corporate content have a high cost and error prone compliance verification process. Lack of confidence in the process means that each person individually looks for documents in attachments to emails, in multiple files and then confers with counsel, advisors and other service providers to confirm they have the correct document.

³ Winters, J. and DiMartino, A. (2005) Development and Evaluation of a Taxonomy for Human Performance Measures. *Department of the Navy – Human Systems Performance Assessment Capability*.

Secure Repository Benefits. In contrast, using a secure repository which manages both documents and the related data substantially improves a company's compliance process because:

- **Structured Filing System.** A filing map with numbering and naming conventions ensures consistency of classification by multiple users. A usable, standardized structure is essential. For example, grouping all Sales Contracts into a single cabinet with folders for Master Service Agreements and Service Orders eliminates guesswork on where to file documents within a compliance repository.
- **Full Audit and Controls.** The compliance repository must create a full audit trail of activities to identify who uploaded each record, who indexed each value and who accessed and downloaded documents. Systematic capture of documents ensures that there is one authoritative repository.
- **Multiple Attributes to Pinpoint Document.** To be effective, users must be able to sort and retrieve documents by any number of attributes, such as division, state, operating unit, asset type, sales territory. Literally, any numbering convention being used in the company to manage data should be superimposed over the documents. This ability to overlay the accountant's numbering convention on legal documents helps the auditors and finance department. This ability enables users to find just the document they want out of thousands in a couple of seconds.

"Knowing that there is only one place to go to find the correct copy of our franchise agreement gives me a great sense of confidence in our ability to meet our compliance obligations."

- CEO of Franchisor

Companies using a secured compliance repository substantially reduce risk and costs as auditors and risk managers can confidently rely on the integrity of the content captured and classified in the system.

Data and Source Documents: linked or independent

While a secure repository improves the compliance verification process, the next level of efficiency is achieved by linking critical data to the source document. Let's compare how this "linking" improves a company's response to a financial audit and due diligence request for a securities issuance.

- **Financial Audit.** Auditors spend a significant portion of the audit verifying that the numbers disclosed in various financial statements and schedules "tie" back to the underlying documentation. To do this, they provide the company with a "prepared by client" request list ("PBC List") and then manually review the documents delivered in response against the data to verify its accuracy.

With linking data to source documents, companies can improve the audit process by indexing documents to the PBC List to validate delivery of requested documents. Next the documents can be indexed by particular financial statement line item or General Ledger number or other accounting classification. This enables auditors to see every contract that "rolls up" into a particular number being verified. For

instance, the rental obligations for all equipment leases included in the rent line item in the income statement.

- **Due Diligence Request.** In a securities offering, attorneys for the company and buyer must perform diligence on the “capitalization table” and then the seller’s counsel must express a legal opinion. This requires reviewing each stock issuance by the company, the basis for exemption from state and federal securities laws, the documents evidencing ownership of the shares and the board approval. The process of collecting all these documents, organizing them and then analyzing them to “foot” to the line item of data in the stock ledger is expensive. Typically it is performed each time an opinion is required with little reuse of prior work.

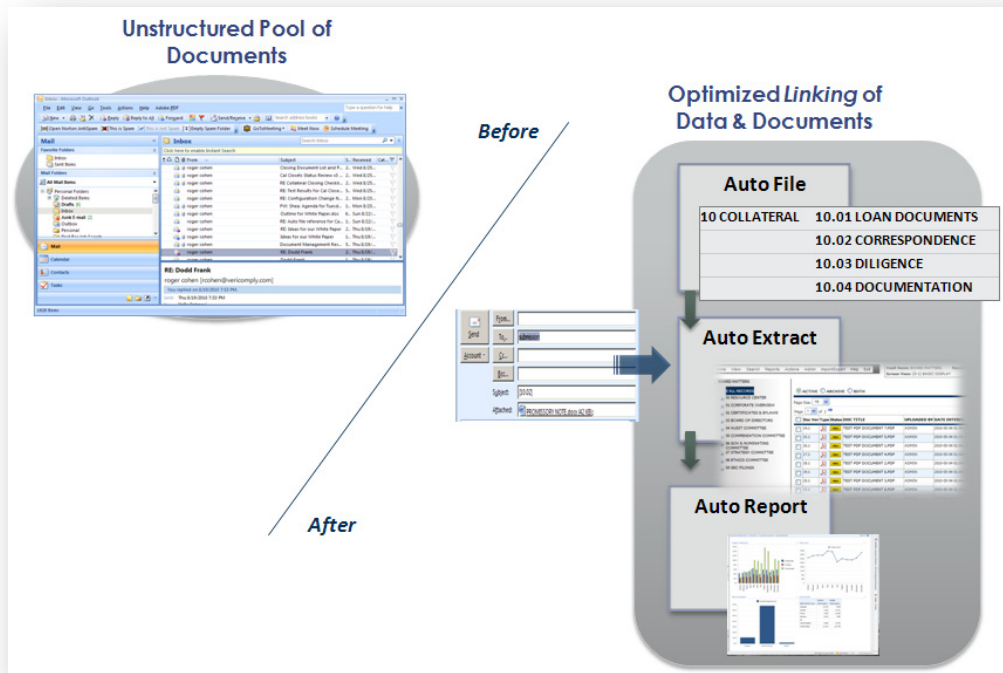
With the linking of data to the documents, the process will be faster, cheaper and more reliable. As the attorney performs his or her review of the stock ledger, the document that supports each issuance can be linked by using a unique ID assigned by the compliance repository to each document. Once the first review and linking is complete, any further review can be performed in minutes.

These are just two examples of the substantial savings and risk reduction that the linking of data and documents accomplishes. Additional savings occur when XBRL tagging is carried back from the disclosure documents to the financial systems and then to the source documents. Responding to multiple, evolving and complex disclosure requirements in shorter and shorter time periods compels companies to link data and source documents to ensure accurate and timely compliance.

Workflow: Traditional versus Compliance

Workflows are essential for efficient handling of documents and data for companies to operate efficiently. Workflows are used for highly repetitive processes performed by lower level employees where the range of outcomes is predictable. The challenge for most companies is that traditional “structured” workflows don’t work: compliance is too complex, obligations constantly changing and too many employees and outside experts who need to participate. As a result, companies typically use “unstructured” workflows such as individual use of excel spreadsheets to track tasks and manage data, emails to communicate and share drives or virtual data rooms to share documents. This unstructured workflow is highly inefficient and cannot be audited, resulting in extra expense and risk.

In contrast, “compliance” workflow can be designed for two distinct purposes. First, to create an authoritative repository of all high value corporate documents, properly classified with appropriate data extracted and documents linked. This workflow includes the first three steps in the typical process (capture, organize and extract) by using email capture and then multiple indexing of the same records with automated extraction where possible and the appropriate level of labor according to the complexity of the task. The result is the most cost effective continuous process for preparing to verify compliance.



Prevent Unstructured Data from Collecting and Pooling

The second part of the workflow is designed for senior executives, attorneys and auditors to perform the last three steps of the Compliance Verification Process (i.e. verify, analyze and act). The workflow for these three steps are performed in a more fluid process, given the nature of the people and the complexity of the process. Email reports, access to a Data/Doc Repository with efficiency tools such as full text search, unique document ids, naming conventions and structured data and documents makes these high cost professionals efficient.

Reports: “Hand Made Reports” versus Automated Push Reports

Timely and accurate reports are an important part of an effective process. Companies without an effective compliance system are forced to extract data by hand from documents, create Excel workbooks, generate reports from these spreadsheets, and then email them to various parties. The process is ad hoc, performed by high cost labor without efficient workflows. The result is expensive and un-auditable, error prone processes, placing the company at risk.

With an effective Compliance Verification Process, the reports used to measure and verify compliance are automatically generated and pushed to the correct decision makers. For instance, real time reports can be sent to risk managers as contracts are captured from operating units, such as sales reports with appropriate attributes that match filters for different recipients. For example, contracts with amount in excess of \$50,000 with foreign companies for a certain product. The key is the ability to get vital data out of contracts into reports that are sent timely to key

decision makers so they have time to respond rather than have the issues arise at the 11th hour when the company is under immense pressure to meet regulatory deadlines. Timely and accurate information enables companies to substitute low cost, low risk processes for high cost, high risk ad hoc, last minute reactions to crises.

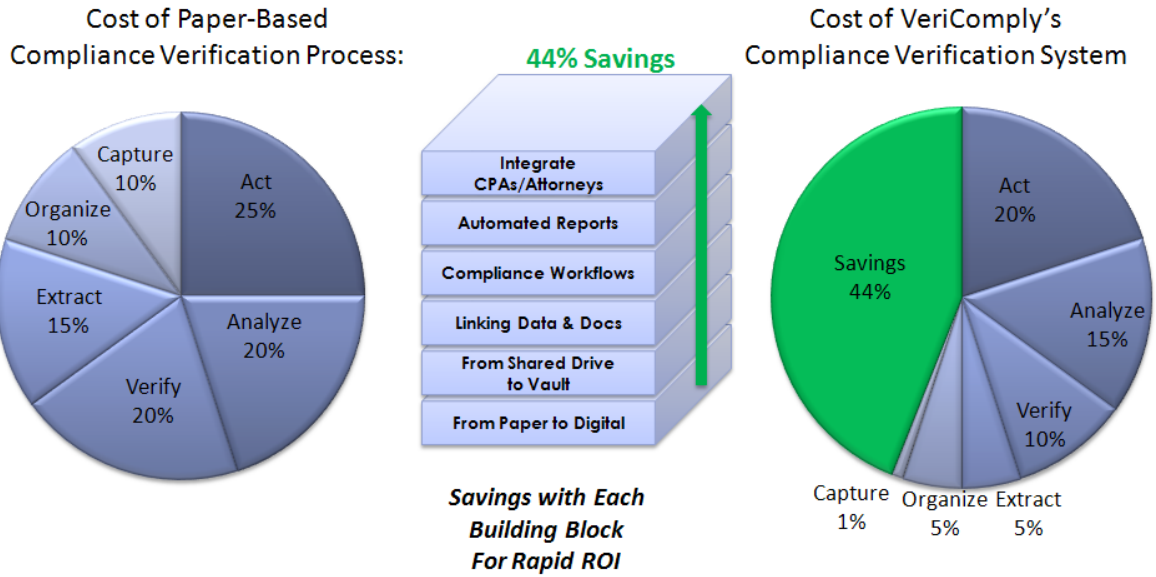
Legal and Accounting Expertise: Separate versus Integrated

The technology and standard operating procedures lay the foundation for an efficient Compliance Verification Process. However, the greatest costs and risks in compliance arise from the interaction with legal and accounting experts. With the rapidity of change, complexity and consequences for failure, companies must consult expensive outside experts for compliance. The challenge is how to reduce the cost of these services without increasing the risk to the company and its officers and directors.

For most companies, a substantial portion of the professional services budget is consumed inefficiently managing information and performing the low value processes of capture, organizing and extracting. Each law firm keeps its own set of documents and then emails it around the office in an ad hoc fashion. Advice is often provided based on inaccurate documents and data. Documents are revised over and over as the facts are finally captured in one place for people to use. Form files are seldom well organized and available for consistent use. The work product of attorneys and consultants is not systematically captured and use for future events. The net result is that the professional service providers are not effectively integrated into the company's compliance process, resulting in high costs and low value retention by the company.

In a fully developed Compliance Verification System, legal, accounting and other expertise is "captured" in the system through classification, naming conventions, and "smart" documents and form files that file themselves in the correct folder. Memoranda, checklists, and workflows explain how to handle complex legally intensive processes such as franchise sales or terminations, loan documentation, preparation of Franchise Disclosure Documents (FDDs), or payment of dividends. Further, the system should capture in real time all the documents, legal pleadings, memoranda and other work product from the company's outside counsel. This work product can be shared to drive down the overall costs of the company.

The result? Up to a 44% reduction in costs, depending on the systemic changes and the degree of repetition and manual processes prior to implementing a Compliance Verification System incorporating all six building blocks. The percentage of compliance costs associated with each stage impacts the overall results, as a company layers in access to digital documents, links to relevant data, and automation, moving, from paper-based to a system to optimize and align people, process, technology, and content.



Conclusion

Companies can reduce their costs and risks of compliance substantially. The ability to transform a paper or share drive based, inefficient process into a highly evolved Compliance Verification System can be achieved with incremental improvements. The key is to assess where your company is today and then lay out an implementation plan that demonstrates a rapid ROI and risk reduction.

VeriComply has developed an assessment to measure the effectiveness of a company's current process and an ROI calculator that shows how the incremental implementation of each of the six building blocks of the Compliance Verification System will affect the company.

VeriComply simplifies and automates compliance for document intensive industries with turnkey solutions that save time and money. Our solutions automatically file documents by email in a secure online vault, extract information from the documents and route the information to each person who needs it to do their job. As a result, we increase the value of companies by accelerating revenue, reducing expense and risk of non-compliance. Our robust Software as a Service (SaaS) model allows customers to get started easily and realize immediate benefits. Verifying Compliance, one solution at a time.

About the Author

Roger Cohen, Esq., is CEO and Founder of VeriComply. VeriComply carries on his vision—developed during 22 years as a corporate attorney with Brobeck, Phleger and Harrison and Dorsey and Whitney—to use technology and process improvement to transform the way executives, boards, and professionals manage corporate content.

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