Ethics: An Overview for Accountants

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CPE Edition published by The CPE Store, Inc., www.cpestore.com, 1-800-910-2755.

Printed in the United States of America

Course Information

Course Title: Ethics: An Overview for Accountants

Learning Objectives:

- Explain the purpose of studying ethics and be excited about the opportunity to improve your ethical reasoning abilities.
- Explain the process of ethical reasoning and how to apply it when specific dilemmas occur.
- List the core values of the CPA profession (integrity, objectivity and independence).
- Discuss the case studies which are presented throughout the course to assist you in maintaining the highest standards of ethical conduct.
- Recite the requirements of the Sarbanes-Oxley Act and the AICPA Code of Professional Conduct as presented in this course.

Subject Area: Behavioral Ethics

Prerequisites: None

Program Level: Overview

Program Content: This course discusses ethical reasoning and its application to common dilemmas that you may experience. It reviews the core values of the CPA profession (integrity, objectivity and independence) and recaps the key requirements of the AICPA Code of Professional Conduct and the Sarbanes-Oxley Act. Throughout this course, you will be provided with case studies that demonstrate the application of ethical principles, values, and ethical reasoning.

Advance Preparation: None

Recommended CPE Credit: 4 hours

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Chapter 1
Introduction

In this course, we will define ethics and provide you with reasons you should be encouraged to continue educating yourself with the goal of achieving the highest standards of ethical conduct.

The course will then discuss ethical reasoning and its application to common dilemmas that you may experience.

Next, we will review the core values of the CPA profession (integrity, objectivity and independence).

Throughout this course, you will be provided with case studies that demonstrate the application of ethical principles, values, and ethical reasoning.

In conclusion, this course will recap the key requirements of the Sarbanes-Oxley Act and the AICPA Code of Professional Conduct.

Ethical Principles and Values

While many of the prior ethics courses you may have taken merely required you to memorize the Texas Rules of Professional Conduct for CPAs, this course will attempt to encourage you to become educated in ethical principles and values as well as ethical reasoning as it applies to common situations that you may experience in your profession.

To begin, it may interest you to understand more about the definition of ethics, ethical principles and values.

Defining Ethics

Ethics (also known as moral philosophy) can be defined as “a branch of philosophy that addresses questions about morality — that is, concepts such as good and evil, right and wrong, virtue and vice, justice, etc.”

Of the various sub-branches of ethical study, the following are the major sub-branches:

- “Meta-ethics, about the theoretical meaning and reference of moral propositions and how their truth-values (if any) may be determined;
- Normative ethics, about the practical means of determining a moral course of action;
- Applied ethics, about how moral outcomes can be achieved in specific situations;

- Moral psychology, about how moral capacity or moral agency develops and what its nature is; and
- Descriptive ethics, about what moral values people actually abide by."

Ethics on the other hand, can also be defined as "the science of human duty; the body of rules of duty drawn from this science; a particular system of principles and rules concerning duty, whether true or false; rules of practice in respect to a single class of human actions; as, political or social ethics; medical ethics."

While the first definition offers a look at ethics as a philosophy, the above definition refers to ethics more as a set of rules and principles.

The term ethics can be defined in many ways. In the context of this course, we will use the term "ethics" to mean a set of rules based on an individual's or specific group's principles and values.

To begin, it is very important to understand that ethics is a science. Many times confused with integrity, which is based on a personal state of being within one's character and is more like an art; ethics are made up of a specific set of rules.

These rules may vary from one arena to another. For example, there are political ethics, religious ethics, social ethics, and professional ethics. Below are some examples of each:

Political Ethics

- Equal air time should be given by the media for opposing candidates
- Prohibiting the use of campaign funds for personal expenses
- Avoiding conflicts of interest between public duties and private affairs
- Judges should not hear cases in which they have a financial interest, a personal bias regarding a party to the case, or earlier involvement in the case as a lawyer
- Public officials are not considered to have accepted an honorarium for work (i.e., speeches) if it is paid to a charitable organization selected by the payor.

Religious Ethics

- Abide by the Ten Commandments
- Go to church
- Read religious doctrine on a regular basis

- Give part of your wealth to the church
- Donate time to the church

Social Ethics

- Avoiding acts which may bring harm to other people
- Protecting the environment
- Going above and beyond the call of duty
- Being responsible for our own actions
- Sharing the wealth with others who may be less fortunate

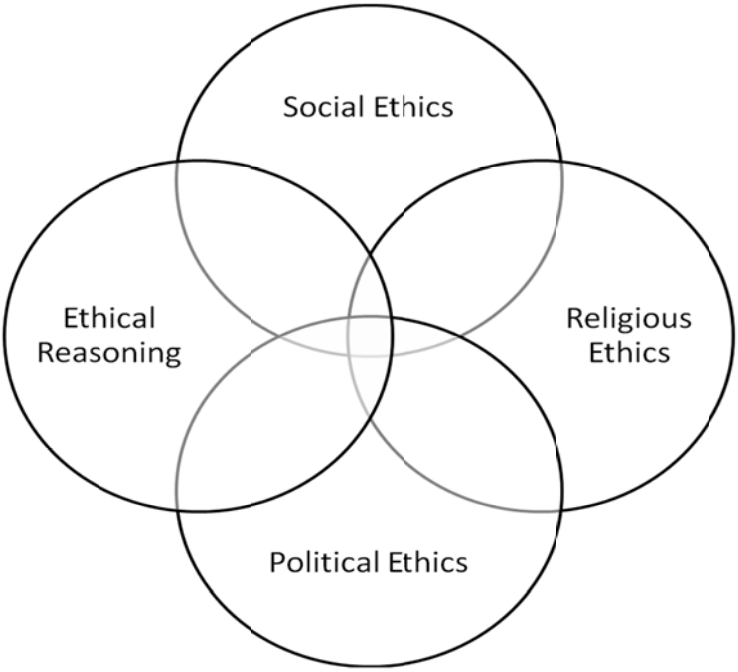
Professional Ethics

- Medical code of ethics
- Legal code of ethics
- CPA code of ethics
- Criminal gang code of ethics
- Computer hacker code of ethics

Although ethics is defined as a set of rules which determine "right" and "wrong" behavior, there is not one set of rules that fit us all. As you can see by the last two examples above under professional ethics, even criminal organizations have codes of ethics. Ethics are defined by various societies, cultures, organizations, religions, etc. Each determines what is "right" and "wrong" based on their group's beliefs and conduct.

While many ethical rules of conduct may have some of the same rules, chances are no two rules of conduct are probably alike. In addition, we all are most likely expected to abide by several different codes of ethical conduct. For example, a CPA must abide by the AICPA Code of Professional Conduct, and also the code of professional conduct for the state in which they are licensed to practice public accountancy. They may also be a member of a specific political or religious organization, in which they have additional ethical rules which they are expected to abide by. They may be involved in a sport, such as golf, in their free time, which has an additional ethical code of conduct.

Many times, conflicts occur when trying to abide by one code of ethical conduct, without breaking the rules of another. For example, one's religious ethical code may interfere with one's political code of conduct. Most people are expected to abide by many codes of ethical conduct all at the same time. This is where ethical reasoning comes into play.



Ethical Principles and Values

Our ethical principles and values are the guides to our ethical decision making, as they provide the direction in which to reason the decision we will make regarding a particular dilemma. For example, if a person truly values people and believes in the principle that all people should be treated equally, they would most likely not be compelled to make any decisions based on racism.

The following are some examples of ethical principles:

- **Autonomy –** Each person should be allowed to make their own decisions based on their lives.
- **Beneficence** – The duty to do good both individually and for all. This principle is mainly associated with the utilitarian ethical theory which we will discuss later in this course.
- **Confidentiality** – The duty to respect privacy of information and action.
- **Finality –** The duty to take action that may override the demands

of law, religion, and social customs.

- **Justice –** All people should be treated fairly.
- **Least harm** – A person should base their decisions on doing the least amount of harm to the fewest number of people.
- **No Harm** – Unlike the principle of least harm, this principle requires the duty to cause no harm, both individually and for all.
- **Publicity –** The duty to take actions based on ethical standards that must be known and recognized by all who are involved.
- **Respect for persons –** A person should honor others, their rights, and their responsibilities as we honor ourselves. In addition, people should not be used as a means to our end.
- **Understanding/Tolerance –** A person should appreciate and accept other peoples' viewpoints, if reason dictates doing so is warranted.
- **Veracity –** A person should always be honest and tell the truth.

While all individuals are encouraged to create their own principles and value system, it should also be recognized that when joining a specific group or profession, you are generally required to also accept the principles and values that as a whole they have agreed upon. For example, when becoming a CPA in the state of Texas each applicant is required to take an oath of office to support the laws and Constitution of the United States and of Texas and the rules adopted by the Texas State Board of Public Accountancy.

There are basically two philosophies used to resolve ethical dilemmas, related to CPAs, which are utilitarianism and rule deontology.

Utilitarianism (teleological ethics)	The promotion that the best long-term interest of everyone concerned should be the moral standard: one should take those actions that lead to the greatest balance of good versus bad consequences.
Deontology (Kantian ethics)	Deals with the concept of duty and the rightness of acts. It emphasizes maxims, duties, rules, and principles that are so important that they should be followed whatever the consequences.

The Purpose of Ethical Education for CPAs

The first professional accountants were known to have originated in England during the late 1800's. However the title of Certified Public Accountant (CPA) was first created when the state of New York, in the year 1896, through the work of its states legislature, passed a law designating the professional status. By doing so, New York also set the path for the process of regulating the accounting profession at the state level rather than the federal level.[1]

Today, all jurisdictions in America have passed accountancy profession laws as well as laws governing all other professional titles within their states. In addition, all American state legislatures still regulate the majority of the administration of the CPA examination, licensing, maintenance and regulation of membership into the accountancy profession. Their regulation includes the specific requirements for continued professional education (CPE) for all CPAs within their jurisdiction.

Accounting ethics are believed by many to have first been introduced by Luca Pacioli (the "Father of Accounting") and later expanded by government groups, professional organizations, and independent companies. Michael J. Fischer, in his paper "Luca Pacioli on Business Profits," concludes that "it appears almost certain that he [Pacioli] would not tell us that there was anything fundamentally wrong or undesirable about engaging in business activities nor the pursuit of profits. In fact, Pacioli indicated his belief that the profit motive is a critical element of the successful business. However, it appears just as clear that Pacioli would strongly advise us to conduct our business both honestly and, perhaps more importantly, with a constant eye toward appropriate conduct of business people – individuals. Further, Pacioli clearly did not suggest that businesspersons should somehow separate their business from their personal lives. Quite the contrary, he indicated that successful businesspersons should see the secular and spiritual aspects of their lives as inextricably intertwined, and further that in the conduct of their business affairs they should "above all keep God before [their] eyes" (Geijsbeek, 1914, pp. 37–38; Brown and Johnston, 1963, p. 34; Cripps, 1995, p. 9)"

[1] "A Reasoned Approach to Reform – White Paper," AICPA, Section II.1, January 2003

While the majority of the CPE which Texas CPAs are required to report each year is technical in nature, the TSBPA does now require that all Texas CPAs also receive training in ethics. Though producing accurate and timely financial statements is the primary purpose of accounting, many people consider ethics for CPAs to be just as important.

Nine Good Reasons to be Ethical (from ETHIX)[2]

1. Litigation/Indictment Avoidance
2. Regulatory Freedom
3. Public Acceptance
4. Investor Confidence
5. Supplier/Partner Trust
6. Customer Loyalty
7. Employee Performance
8. Personal Pride
9. It's Right

While most, if not all, CPAs agree that a CPA should achieve and maintain the highest standards of ethical conduct, there has been much controversy as to the effectiveness of ethics courses in accomplishing this goal.

Can you actually teach someone to starve before they would steal food? Most believe that although education like the threat of punishment cannot completely eliminate unethical acts such as theft, it can greatly reduce the probability of it occurring.

The technical training we receive as CPAs does not eliminate the possibility that we will err in the way we choose to account for a particular transaction, however; it significantly reduces the probability. Likewise, ethics training that we receive will not eliminate the possibility that we will not exercise good judgment in a particular situation, but it will greatly reduce the probability.

[2] ETHIX, Bulletin (1), http://www.allbusiness.com/accounting/214505-1.html

Case Study

In 1993, Mary Beth Armstrong completed a study (Mary Beth Armstrong, "Ethics and Professionalism in Accounting Education: A Sample Course," Journal of Accounting Education, 1993), in which she provided data demonstrating that an accounting ethics course can increase a participant's ethical sensitivity.

Armstrong tested all students at the beginning and the end of the semester, using Rest's Defining Issues Test. Her data indicated that those students who had already taken a general ethics course and who also took the ethics and professionalism course scored significantly higher on Rest's Defining Issues Test. An increase in one's ethical sensitivity is thus the result of a synergy of academic experiences in ethics, she concluded.

Rest's Defining Issues Test (DIT), developed by James Rest in 1979, is designed to assess a person's stage of moral development. The stages used are based on Kohlberg's approach to morality, which places individuals into one of the following six stages of moral development:

- Stage 1: The morality of obedience: Do what you're told.
- Stage 2: The morality of instrumental egoism and simple exchange: Let's make a deal.
- Stage 3: The morality of interpersonal concordance: Be considerate, nice, and kind: you'll make friends.
- Stage 4: The morality of law and duty to the social order: Everyone in society is obligated to and protected by the law.
- Stage 5: The morality of consensus-building procedures: You are obligated by the arrangements that are agreed to by due process procedures.
- Stage 6: The morality of non-arbitrary social cooperation: Morality is defined by how rational and impartial people would ideally organize cooperation.(Rest, & Narvaez, 1994, p. 5)

Seven Goals of Accounting Ethics Education

- Relate accounting education to moral issues.
- Recognize issues in accounting that have ethical implications.
- Develop "a sense of moral obligation" or responsibility.

- Develop the abilities needed to deal with ethical conflicts or dilemmas.
- Learn to deal with the uncertainties of the accounting profession.
- "Set the stage for" a change in ethical behavior.
- Appreciate and understand the history and composition of all aspects of accounting ethics and their relationship to the general field of ethics. —Stephen E. Loeb[3]

[3]Stephen E. Loeb, 1988, "Teaching Students Accounting Ethics: Some Crucial Issues"

Study Questions

1. Ethics is which of the following?
    A. An art
    B. A science
    C. A state of being
    D. A set of rules that apply to all humans

2. Ethical reasoning is most likely to occur when which of the following happens?
    A. One is giving a political speech
    B. One is attending church
    C. Two codes of ethical conduct are based upon the same sets of rules
    D. When trying to abide by one code of ethical conduct, without breaking the rules of another

3. Most people are expected to abide by how many codes of ethical conduct?
    A. One
    B. Two
    C. Three
    D. Many

4. How do our ethical principles and values relate to our ethical decision making?
    A. They are inherited
    B. They are absent
    C. They are our guides
    D. They are one and the same

5. Which of the following are the basic two principles used to resolve ethical dilemmas, related to CPAs?
    A. Good and bad
    B. Right and wrong
    C. Utilitarianism and deontology
    D. Utilitarianism and teleological ethics

6. Which of the following is the reasoning that the best long-term interest of everyone concerned should be the moral standard?
    A. Utilitarianism
    B. Teleological ethics
    C. Deontology
    D. Utilitarianism and Deontology

Answers to Study Questions

1. A. Incorrect. Integrity is an art.
   B. **Correct.** Ethics is a science based on a set of rules.
   C. Incorrect. Integrity is more of a state of being.
   D. Incorrect. There is no one set of ethical rules that apply to all humans. Rather, there are many sets of rules that apply to various groups.

2. A. Incorrect. Most likely, when one is giving a political speech, they are conducting themselves within their political ethics rules.
   B. Incorrect. Most likely, when one is attending church, they are conducting themselves within their religious ethics rules.
   C. Incorrect. When two codes of ethical conduct are based upon the same sets of rules, it usually does not require one to use reasoning to decide which code to abide by.
   D. **Correct.** Many times, conflicts occur when trying to abide by one code of ethical conduct, without breaking the rules of another. For example, one's religious ethical code may interfere with one's political code of conduct. This is where ethical reasoning comes into play.

3. A. Incorrect. While a person might be expected to abide by one professional code of conduct, they may also be expected to abide by a religious code of conduct.
   B. Incorrect. While a person may be expected to abide by a code of conduct at work and at home, they may also be expected to abide by an ethical code on the golf course.
   C. Incorrect. While a person may be expected to abide by codes of ethical conduct at home, at work, or while attending a political meeting, these may not be the only codes which they are expected to follow.
   D. **Correct.** Most people are expected to abide by many codes of ethical conduct all at the same time. Many times, conflicts occur when trying to abide by one code of ethical conduct, without breaking the rules of another. For example, one's religious ethical code may interfere with one's political code of conduct. This is where ethical reasoning comes into play.

4. A. Incorrect. While a person might be influenced by their heredity, they are not born with principles and values.
   B. Incorrect. Principles and values may be ignored but they are always present.
   C. **Correct.** Our ethical principles and values guide us as we use ethical reasoning to make decisions regarding potential conflicts.
   D. Incorrect. Remember that different people have different ethical principles and values.

5. A. Incorrect. Ethical reasoning is different for everybody so what one may believe to be good for example, another might consider to be bad.
   B. Incorrect. While many sets of principles and values may have rules which relate to what they believe to be right or wrong, this does not relate to dilemmas.
   C. **Correct.** When potential conflicts arise (dilemmas) the general principles used to resolve them include utilitarianism and deontology.
   D. Incorrect. Teleology can be defined as the study of design or purpose in natural phenomena.

6. A. **Correct.** Utilitarianism is the reasoning that the best long-term interest of everyone concerned should be the moral standard.
   B. Incorrect. Teleological ethics is the reasoning that one should take those actions that lead to the greatest balance of good versus bad consequences.
   C. Incorrect. Deontology is the concept of duty and the rightness of acts.
   D. Incorrect. While Utilitarianism is the reasoning that the best long-term interest of everyone concerned should be the moral standard, Deontology is not. Many times, conflicts occur when trying to abide by one code of ethical conduct, without breaking the rules of another. There are basically two principles used to resolve ethical dilemmas, related to CPAs, which are utilitarianism and rule deontology.

Chapter 2
Ethical Reasoning and Dilemmas

"If only there were evil people somewhere insidiously committing evil deeds and it were necessary only to separate them from the rest of us and destroy them. But the line dividing good and evil cuts through the heart of every human being."
— Alexander Solzhenitsyn, in The Gulag Archipelago

Largely due to the recent corporate scandals at Enron, WorldCom, Arthur Anderson, etc. involving senior management and CFOs manipulating the books to make their companies appear more profitable, more and more research has been done to investigate the ethical reasoning and dilemmas that CPAs are faced with on a regular basis. The largest part of the prior research projects which have been done on ethical issues in accounting have generally avoided theoretical discussions about "right and wrong" or "good and bad" choices. Instead they have focused on determining whether or not accountants are abiding by the rules of professional conduct.

It is believed that the intense pressure put on the CPAs at the organizations which have collapsed recently, had a huge impact on them and ultimately led them to compromise their ethics. While we all understand that CPAs should not allow these pressures to interfere with their ethical, legal, and moral standards; sometimes this is easier said than done when face-to-face with an actual dilemma of our own.

While it usually seems that the difference between "right" and "wrong" is very clear, it is closer to the truth that no two people in the world would agree on the same ethical codes of conduct to define "right" and "wrong." Each of us has our own unique ability to ethically reason through conflicts which may arise within our own personal codes of ethical conduct. It is through this reasoning that we are forced, most likely on a daily basis, to determine what is ethically appropriate in our actions.

In the same respect, the way that we "reason" is not the same for all of us. For example, consider two people in a parking lot outside of a convenience store talking. During their conversation, a man leaves the store and accidentally drops a $20 bill. He does not notice it and proceeds to get into his car and leave. Both of the men having the conversation notice the man dropped the $20. While one of the men quickly picks up the $20 and laughs that good things happen to good people as he starts to put the money into his pocket, the other man quickly tries to flag down the owner of the money to give it back to him. How is each of these men using ethical reasoning to ultimately drive their actions?

The man who wanted to pocket the money may have reasoned that, although his religious ethical rules of conduct would not have permitted him to keep the money, he was not in church at the time. He also was expected to abide by his business's ethical rules of conduct, which stated that all is fair in love and money.

However, the other man who flagged down the owner of the $20 reasoned that while his business also had an ethical code, which stated that he should always put his company's values first, he was also obliged to abide by his social ethical code, in which he was obligated to treat his neighbor as he would want to be treated.

The Reasoning Process

When resolving ethical dilemmas, Iris Stuart recommends an ethics model consisting of the following four steps:

1. The accountant must recognize that an ethical dilemma is occurring.
2. The accountant must identify the parties that would be interested in the outcome of the dilemma.
3. The accountant must determine alternatives and evaluate the effect of each alternative on the interested parties.
4. The accountant must select the best alternative.[4]

Case Study

A study was published in 1994, to determine how 100 randomly selected accountants, specifically auditors, used ethical reasoning when confronted with issues related to client confidentiality, Rule 301, *Confidential Client Information*, of the AICPA's Code of Professional Conduct.[5]

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[4] Iris Stuart, 2004, Ethics in the Post-Enron Age. SouthWestern/Thomson.p. 6. ISBN 0324191936

[5] "Ethical reasoning in confidentiality decisions," by Barbara L. Adams, Fannie L. Malone, and Woodrow James, Jr., The CPA Journal, July 1994

In this exercise you are asked to review the scenarios they were provided and respond to each circumstance described using the following guide (as originally provided in the study):

- To inform or not inform a third party of confidential client information,
- Indicate which response given in 1) is considered "good ethical behavior" if the Code was disregarded, and
- Justify your answers.

♦ Scenario 1 ♦

James Corporation employs the regional CPA firm of Green and Cash to audit its financial statements. The firm has been asked to prepare quarterly financial statements for the first quarter of 1986. Bob Ethics, a staff accountant, was assigned to do the work. During the course of preparing the statements, Bob discovered that James Corporation materially understated net income on last year's tax return. Bob informed his supervisor about this and the client is asked to prepare an amended tax return. The client, however, refused to take corrective action.

What would you do? Why?

After tallying the results for scenario 1, the study concluded that "given a Code, most (78%) respondents would not inform the IRS. This is in agreement with the rule of conduct. Although the variability increased, most CPAs (70%) in this situation, would make the same decision without a Code. This is consistent with the justification given that most CPAs perceived themselves to be an advocate of the client in a tax engagement. There was no perceived conflict in the rule of conduct and what most accountants perceived as good ethical behavior."

♦ Scenario 2 ♦

Johnson Manufacturing Corporation is a publicly owned company that manufactures equipment used by hospitals and medical laboratories. The company is audited by the national accounting firm of Adams & Pitre. One day, John, the senior in charge of the engagement overheard a conversation between two managers indicating that although they met inspection standards, they were aware of a defect in a particular piece of equipment, but they had not notified any of their customers because they felt the probability of malfunction was low. John takes this information to the controller and is told not to include it in the audit report. He then takes it to the manager on the engagement. The manager informs University Hospital, one of its clients, and also a major customer of Johnson Manufacturing Corporation, not to purchase any more equipment from Johnson. Johnson sues Adams & Pitre for violating the confidentiality rule.

What would you do? Why?

After tallying the responses to scenario 2, the study found that "most CPAs (78%) responding in this situation would adhere to the Code and not inform one client of information discovered while auditing another client. A large percentage (52%) of respondents, however, indicated that informing would be the "best ethical behavior." In most instances, "potential safety concerns" were cited as the justification for considering informing as the "best ethical behavior." Thus, there appears to be some conflict in adhering to the Code and the moral value of some CPAs."

♦ Scenario 3 ♦

William Johnson, a CPA, served as a director of Last National Bank for a year. As a director, William may be held liable for damages if he fails to use care and prudence in administering bank affairs and such action causes the bank to suffer a financial loss. In the course of an audit, William discovered a seriously weakened financial position in a client who has a large loan at Last National Bank. Disclosure of this condition to the other bank directors would minimize the bank's loss, however, since the audit has not been completed, this would represent a violation of Rule 301 of the Code.

What would you do? Why?

From the responses to scenario 3 that were received in the study, it was determined that "given a Code, a majority (78%) of CPAs would not inform, which is in agreement with the Code. A lesser percentage (53%), however, feel this is the best ethical behavior."

In conclusion, the study stated the following:

> *"The findings of this study indicate that CPAs usually adhere to the Code (rule deontology) in resolving issues involving*

confidentiality. However, such decisions are not always in accord with what they perceive as "good ethical behavior." The broad principles of the Code indicate that ethical conduct, in the truest sense, means more than abiding by a letter of a rule. It means accepting a responsibility to do what is honorable or doing that which promotes the greatest good to the greatest number of people, even if it results in some personal sacrifice. Somehow, the profession needs to emphasize the "greatest good" criterion more strongly in applying the rules of conduct."

Ethical Reasoning and Business

Wikipedia defines the term "business" as follows:

"…a business (also called firm or enterprise) is a legally recognized organizational entity existing within an economically free country designed to provide goods and/or services to consumers. Businesses are predominant in capitalist economies, where most are privately owned and typically formed to earn profit to increase the wealth of their owners. The owners and operators of a business have as one of their main objectives the receipt or generation of a financial return in exchange for their work and their acceptance of risk."

All of us in business understand that the main objective of a business is "the receipt or generation of a financial return." But we also have no doubt all been put into a position, while conducting business, where we had to use ethical reasoning to make decisions based upon whether generating profit should be held above all else.

A Case Study

On September 29 and 30, 1982, seven Chicago area residents ingested Extra-Strength Tylenol capsules that had been laced with cyanide. Within a matter of hours, all seven were dead. The murders triggered the largest product tampering investigation in the history of modern law enforcement, with nearly 120 investigators from various state and local law enforcement agencies and FBI Special Agents working around the clock to identify the person or persons responsible for the poisonings.

Johnson & Johnson, the manufacturer of Tylenol, was faced with the possibility of potential disaster. Tylenol accounted for approximately 18% of its total corporate revenue. The organization was faced with making a decision on how to react and at the same time, did not have answers to the following questions:

1. Were these deaths just the first of many to come?
2. Was the incident confined to the Chicago area or would other cases outside the area emerge?
3. Were the Tylenol capsules laced during the manufacturing process, or did the crime occur after they had been distributed to resellers?

Although the Food and Drug Administration (FDA) did issue a statement immediately warning the public of the potential danger, they did not require Johnson & Johnson to do a complete recall of its product. The FDA decided to leave that decision up to the manufacturer.

What Johnson & Johnson did know is that it did not have insurance that would cover the millions of dollars of lost income a total recall would likely produce. There was also a good chance that a total recall could so damage the reputation of the Tylenol product, that it would never be able to regain its 37% of the over-the-counter analgesic market share.

Despite the gloomy outlook for the organization, the Board of Directors for Johnson & Johnson ultimately decided to issue a total recall of its Extra-Strength Tylenol capsules. Deciding that protecting the welfare of the general public was their priority, even at the risk of a huge potential loss for the company, paid off for Johnson & Johnson in the end. The company's reputation remained strong and no other deaths were reported.

No one was ever charged with the murders, although a 37-year old New York man, James Lewis, was charged with attempting to extort $1 million dollars from Johnson & Johnson. Lewis was convicted of the attempted extortion following a trial in U.S. District Court in Chicago and was sentenced to 20 years in prison.

Greed

One of the most common reasons CPAs compromise their ethical values is due to greed. Greed, an excessive desire to possess wealth or goods, can be so overpowering that many times it so overwhelms us that we do things we know are wrong. Most that are driven by greed always seem to somehow find a way to justify their actions, in a way that convinces them that what they are doing is not really unethical.

The following case study is an abbreviated version of what happened to one corporate executive (who chooses to remain anonymous). In his own words, the once successful executive describes how he let greed interfere with his otherwise moralistic manner of doing business. It is his hopes that by sharing this story, he will be able to help others avoid the pitfalls that he encountered. Italicized below are the points that he specifically would like to emphasize.

Case Study

How It All Began

It had been six years into a very prosperous career in the financial services industry and one year into my tenure with a new company. Then it all began one winter night as I drove home from a long day at work. Back then, I was going through some minor financial hardship. I basically had an outstanding debt of approximately $6,000, which had been weighing heavily on my finances. The year before, my father passed away and I had to support my mother financially. In so doing, I racked up some debt to pay for her living expenses until things came back to normal. I also racked up some sense of frustration over my inability to be financially capable and mange to support my family with more ease. Of note, my salary then was already in the range of $60K a year, a figure that could've been enough to get me through my debts in due time, but for various reasons, I just couldn't manage on.

As part of my job, I was solely responsible for managing the relationship with several vendors and had discretion over handling invoices and payments to them. These expenses ran in the range of $50-$80K a year. Specifically there were two vendors, which as I will explain, both became components of my scheme, without their knowledge that is. Let's call them vendor A and vendor B. Vendor A was responsible for providing research tools and analysis. Vendor B provided all the technology support for vendor A, but I paid them both directly.

Towards the end of the year, vendor B, the technology provider, withdrew from the contract because I had objected to their dramatic raising of fees. Following their departure, and under pressure from me (with no malicious intentions), vendor A hired a technology consultant on a full time basis, who was tasked with providing the same services that the old vendor provided. This new arrangement translated into savings of tens of thousands of dollars, as the cost of hiring that consultant was much smaller than paying the old vendor for virtually the same services. Also worth mentioning, the departure of the old vendor and the delegation of their technology support services to the remaining vendor did not become known to my superiors. It just so happened that the new arrangement transpired very quickly.

So back to that one night when I was driving home from the office: In the weeks before, I had received notices regarding my outstanding debts and I was stressing about it. So sitting in traffic, listening to the radio, I had the first glimpse of an idea: Since I saved a lot of money with this new vendor arrangement, what if I could utilize some of those savings; kind of give myself a bonus, to help me get out of debt.

I thought to myself that this would be just an isolated act that did not represent who I was as a person. I justified to myself that tapping into those supposed savings of a few thousand dollars would hardly impact the company financially, given its colossal annual revenues of over a hundred million dollars. I told myself that it would only amount to rewarding myself for my successful negotiations, which had led to the drastic reduction in the cost of vendor services. Most notably, I convinced myself that this would be an exceptional one-time transaction, not a continuous scheme, and was by no means an act of fraud.

Lying To the Mirror

If there's one phase of fraud's psychological continuum you need to watch out for, this beginning phase is it! It's that point before you actually cross the line, but when you begin rationalizing why crossing the line is justified. For me that very moment was on that winter night when I rationalized to myself that stealing money from my employer was not theft but rather a business transaction. Sure enough, almost every embezzlement offense I've read about had traces of that same dynamic: the offender rationalizing that his action was justified, or that it didn't represent who they are or that it was something less deplorable than what it really was- fraud!

As you're reading this, and if you're encountering a similar situation, I recommend that you take an honest look at any wrong actions you've taken or are about to take. Most likely that corrupt choice was justified by a giddy rationale, which conveniently made your self-serving behavior seem acceptable. Believe me, once you cross that line, turning *back just gets harder and harder. You have to remember that in my case and prior to that date, I had never done anything remotely close to this. So if you're thinking to yourself, "the fraud I'm committing does not represent who I am. Really I'm not that kind of a person…," well you better think again. You know the old adage, "stupid is as stupid does"? Well the moment you commit a crime, you ARE a criminal, regardless of whether it's your first offense. Further, believing that you are a decent person ─and you may be indeed─ does not give you impunity from doing indecent things. Who we are is more a reflection of what we do than who we believe we are.*

Sure enough, I considered myself a decent person. I truly did. I based this self-assessment on my dignified views of people and of the world, which lacked rancor or envy. I based it on my lifelong encounters with family, friends and teachers, to whom I always showed respect and tenderness. I based it on the various points of my history where I often opted to do the right thing at the expense of giving up something in return.

But the moment I committed fraud is the moment I ceased to be a decent person. What I did is what mattered; not who I thought I was. Ask yourself this simple question: Is what I'm doing illegal? The answer should be a simple yes or no. No explanation of how decent you [otherwise] are should matter.

Fraud Triangle

I did not linger at the question. I slipped right through it with my faulty reasoning, fueled by a need for money. I worked out my plan as follows: I would establish a new corporation that bore a similar name to vendor B, who no longer provided us services but their departure was unknown to my superiors. Using fictitious invoices that looked exactly like the ones vendor B used to send us, I would create invoices for work that was no longer done by that vendor but that was being provided by the other vendor, who I legitimately paid separately. I would submit those invoices to Accounting and would request to pick up the checks personally under the excuse that I needed to overnight them myself to ensure proper delivery. I would then deposit the checks into a bank account that I would establish for that new shell company.

Once I paid off the debt, I would stop. Further, I vowed to myself that as soon as my financial situation improved, I would pay back the money by making a direct payment to the remaining vendor out of my pocket in the same amount that I tapped into.

Once again I point to the conniving nature of "rationalization," which is the cornerstone of all embezzlement offenses. Criminologists call it the Fraud Triangle: Existence of Pressure (financial need) and presence of Opportunity (money,) followed by Rationalization that the wrong behavior is justified by valid reasons. For the weak of will, these factors combined could give birth to fraud, especially in the absence of a strong moral code. And in my case, they did.

No Turning Back

So it was, I established a corporation that bore a similar name to vendor B. I then opened a bank account for that corporation. I turned in my first invoice for the amount of $8,500 using the template from the original vendor that was emailed to me. I requested that accounting provide me the check personally. I picked up the check and deposited it into the bank, where I had been a regular client, and the slight difference between the name on my account and the name to whom the check was payable went unnoticed. The first transaction went smoothly. I transferred the money from my business account to my personal account and paid off the debt in its entirety. I planned to close the business account the next day and dissolve the shell company.

A day later, I had not done that. I was very busy with work and just decided to put it off for another week or so. A week later I still had not done that. A month later I still had not done that. A couple of months later I needed money again and I repeated the process, albeit for a much smaller amount. After that, I just couldn't stop. Over the course of two years, I had generated over a dozen invoices and received an equal number of checks for what eventually amounted to nearly one hundred thousand dollars.

So how did I make the leap from a one-time transaction to an ongoing process? As pitiful as any explanation may sound, the merits of the additional income simply blinded me. The monetary reward made my initial flawed justification all the more believable: I wasn't committing fraud; I was just tapping into the savings that I managed to yield! The depths of my action (betraying my employer) and the possible repercussions (legal and professional) all languished in the background, overshadowed by the handsome financial rewards and suppressed by the seemingly acceptable rationalization (I wasn't hurting the company financially!)

Intentions Don't Count

Criminologists also describe another dynamic in the mindset of the embezzler, something called "wages in kind." This occurs when the embezzler believes he's entitled to the assets he's stealing. There's the famous tale about the bookkeeper who was denied a $100 monthly raise. Over the next 10 years, he embezzled a total of $12,000 in the form of $100 a month of fraudulent payments to himself, the same raise amount he had asked for!

In my case, I did not have any such entitlement claims. On the contrary, during the couple of years following the beginning of the scheme, my prominence in the company was rising exponentially. I had built a name for myself in the industry as a research analyst and generated a lot of publicity for the company through my various research papers. I won employee recognition awards, I was allowed to hire more staff and I basically had a very rewarding job in more ways than one. In all honesty, I truly was passionate about the company and my work, and was known around the company for my uplifting demeanor and my positive attitude. I sincerely cared about the success and future of the company.

Paradoxically enough, having this genuine heartfelt admiration for the organization made me all the less guilt-ridden about what I did behind their back. It somehow alleviated the awfulness of my actions. The incongruity of my rationale reminds me now of an episode of Sex and The City, where a female character walks in on her boyfriend having sex with another woman. The man caught red handed looks at her and says "This is just sex, but I love YOU!"

Equally delusional, I convinced myself at the time that cheating on the company was not necessarily deplorable, since I truly cared for them! But now that I look back at those years, I realize that I did hold some of those unfounded "wage in kind" views. To the extent that I believed I was making a lot of money for the company and truly cared for their well-being, I rationalized that diverting some additional income to myself was not entirely unconscionable. Oh how we fool ourselves!

As you're reading this, and if you're encountering a similar situation, once again I ask you to honestly examine the nature of your action. If you believe you're entitled to some additional privilege from your employer, that's understandable. But know this: when in the midst of fraud, one often looks for and finds easy ways to justify his actions. With me, it started with the rationale that I was capitalizing on some savings I had earned for the company. Then I rationalized that the *company's financial state was so strong that my theft would not impact it. Then I believed that my genuine passion for the company neutralized the fact that I stole from them. The point is that you'll never run out of frivolous reasons to justify your actions. What I advise you to do is to admit to yourself that no one reason justifies stealing from your employer (or anyone else for that matter.) If that's not enough to stop you, then think of the hefty price you'll pay in the end compared to the forgone privileges to which you believe you're entitled. For me, I'm going to prison very soon; a hefty price indeed!*

Above all, remember that your biggest enemy is yourself. Look at the outrageous excuses I used to justify my behavior (I made them money and so a little theft is okay!) I think I just wanted to believe any excuses, as senseless as they were, so that I could suppress the guilt I was feeling. And this was my biggest lie: I believed that I believed my lies! The truth is, in all of this, the person I deceived the most was not my employer; it was me.

So stop lying to yourself and face the truth. There is a reason [individuals] with substance abuse problems begin their therapy by first admitting that they ARE substance abusers. Acknowledging your wrongdoing is the first and most critical step to end the fraud. Without it, your lies will just get bigger and your chances of stopping will get smaller.

Fear subsided

Now you have to wonder though: guilt aside, do embezzlers fear getting caught? Did I? Would you?

For me, the answer is yes, I did, well at least in the beginning. But with time, this act seeped into my life and became simply an accepted fact of my existence. I was so blinded to reality by the hypnotizing effect of money that I completely discarded any attempts to confront the fearful repercussions of my actions. As idiotic as it may sound, I got to a point where I almost forgot about the scheme, I just did it! Do I sound fearless to you? Think again. It wasn't the lack of fear that blinded me; it was the greed, the money, and most of all, the denial. I avoided facing reality by digging my head in the sand pretending that if I didn't see the problem it would just cease to exist.

There's a famous fraud story about this CFO who had sole control over the accounting systems at a mid-size bank. One day he tapped into some funds in one account and managed to conceal it through making fake reverse entries in another account. He did this for a few years completely undetected and amassed over $150,000 in illegal funds. Then one day, a customer made a double payment to the bank. The redundant check was forwarded to the CFO for processing. Get this, after sitting at his desk untouched for a week, the CFO finally took the check, endorsed it to himself and deposited it directly into his account! When the customer got the returned check and realized the foul play, he called the company and eventually an outside audit uncovered the entire scheme.

So why do you think the CFO went as far as to make such an incriminating move signing his own name on a client's check? Was he fearless?

Absolutely not! Like me, his greed grew over time to the point that he became incapable of reasoning. Hardly an excuse for his illegal actions, or mine for that matter, but the point I'm driving home is that after a while, you're bound to lose sight of reality. If you thought it was hard to control your actions in the initial stages, wait until you get farther along. Greed overpowers fear, especially when you grow accustomed to the financial rewards. So be wary, if you're already in the midst of committing fraud, it's NOT too late to stop. If you use the rationale of "I'm too far along in this mess to stop now," you're wrong. It will only get worse from here, both in legal terms and in the sense of your ability to stop. And if you think your lack of fear is a sign of your infallibility, you're wrong again. The absence of anxiety is rather a sign that you're so enmeshed in your foolish behavior that its severity doesn't faze you anymore. Sooner or later, your foolish behavior will catch up to you, as it did to me.

Reality Hits

Nearly two years into my scheme, someone in accounting noticed a discrepancy in two of the fictitious invoices I had submitted. In less than two days, a simple audit managed to uncover the entire scheme. One Monday morning in the office, I was confronted with the findings and I admitted my crime and provided full details about the nature of the scheme. I was fired on the spot and was told to expect legal action against me. Here's the horrifying part, and I'm being truthful when I tell you this: When they confronted me about the scheme, for a split second I couldn't tell if I had truly done this or if I had just once thought about doing it! I know it sounds silly, perhaps even pathetic. But this is another of greed's many tricks: it gives birth to other traits. In my case, one of those traits was none other than "denial." So it was that when I got into my car and drove home, I had only one thought in mind: Suicide. I couldn't face what I had done. I couldn't face what awaited me!

When denial is reversed, all you're left with is a big shock. And in my shock, I could think of no other way to avoid the shame awaiting me except by not being there to face it. Worse yet, I just couldn't stand myself; I resented every last breath of my existence. In a way, I really wanted to punish myself!

To spare you the morbid details, my suicide attempt was not successful. I slit my wrists multiple times and swallowed 90 pills of a sleeping aid, but ended up losing consciousness for 36 hours and losing little blood. When I woke up in a daze, not sure if I were dead or alive, I immediately called my fiancé and my brother, who came to my aid. I only lived because I missed the veins.

After recovering from that initial shock, I came to my senses and realized what had really happened. I retained the services of an attorney and attempted to reach a civil compromise where I'd pay back the money, which I had already spent over the course of two years.

The more I regained sight of reality, the more I realized how bleak that reality was. But I knew that despite whatever state of denial I was under in the past two years, my actions were real and I had to take responsibility for them. I waited, and two weeks later, I was arrested at my home.

The Aftermath

I'm now out on bail, awaiting my sentencing. I expect to begin my incarceration very soon. Due to the nature of my role, I have also been barred from the securities industry for life. Predictably, I'm liable for all the funds I embezzled and will be ordered to pay them in full (I already voluntarily began paying back some of the money with the help of my family.) In addition, the legal fees I've incurred in the process already amount to nearly what I stole. But this is nothing compared to the intangible damage I've caused. The news of the whole incident was made public and virtually everyone who had any association with my employer, my colleagues included, became fully aware of the whole ordeal. Shame and a tarnished reputation will haunt me forever. In committing my act, I have betrayed so many people who trusted me; a breach of trust of which I'm reminded every other day in my nightmares. I've disappointed those who believed in me, and gave them reasons not to ever believe again. Worse yet, I've disappointed my family, especially my mother, who despite the support she gave me during my crisis, her disappointed eyes can’t help but tell the truth.

You know, some mistakes are reversible and some damage is reparable. But with tales of betrayal, much like the cheating boyfriend story I mentioned earlier, there is little you can do to alleviate the harm you caused to others and to yourself, especially the legal consequences. All that’s left to do is to turn this saga into an experience that makes a better person out of you, not a worse one. But believe me, you’re much better off not having to go through it in the first place.

The Right Choice

So in my final words to you, I’ll say this: laws exist not just because someone imposed them upon us; they exist because they’re right! They validate human concepts, which even without the existence of [those laws], are still sensible. Stealing money that doesn’t belong to you is the wrong thing to do, even if law didn’t prohibit it.

But there IS a law that prohibits it, and when you break that law, there are dreadful repercussions waiting for you. Those repercussions, including going to jail, are life-altering and their damage will haunt you for the rest of your life. The ramifications of your actions will not only affect you but will also hurt your family and loved ones. Greed and denial will make you lose sight of those consequences or even ignore them. Don’t let them blind you. Instead, do the right thing: Stop the fraud now or just don’t start it. You have the choice. Believe me, I’d do anything to go back in time and make that right choice. But I can’t, so instead, I hope to help others do so.

I wish you the best of luck doing the right thing and staying out of trouble!

— *Someone who’s been there.*

Once I read the above story, I had some additional questions which the gentleman who wrote the above story kindly agreed to answer. The following are a few of the questions I asked:

Question: What, if anything, do you think could have been done by those around you which may have prevented you from embezzling the funds?

Answer: I think if someone were to bring to my attention a similar story like the one I'm now sharing with the public, it would have likely brought me to my senses and made me see what I was doing for what it REALLY was. One of the problems is that embezzlers often unconsciously alter their perception of reality in a way that effectively subsides their guilt and quells their fear. But a reality check in the form of hearing or reading about someone else's horrid tale is bound to bring them out of that self-induced hypnosis and make them stop. Further, I think it has an even higher chance of deterring then from embarking on the fraud in the first place.

Question: If you hadn't been caught, do you think you would have stopped by yourself?

Answer: Yes, I think I would have.

Question: Without implicating anyone else, did you tell anyone and if so, what was their reaction?

Answer: No, nor did I feel the urge to. I used to tell friends that I do some consulting on the side; and after a while I sort of believed I did!

Question: Did the idea of “getting away with it” excite you or was it all for the money?

Answer: I never thought about getting caught. My view of the whole situation conveniently ended at the part where money entered my bank account. But I can tell you for sure that I did not get any kicks out of doing it either. I loathed turning in the fake invoices and dreaded even more going to bank to deposit the checks. My research on the topic, however, tells me that some people do enjoy the "drill." I wasn't one of them.

Question: If you were to start your own company, what would be the most important types of controls that you would put into place to prevent someone from embezzling from you?

Answer: Besides, the obviously recommended ones (separate duties, monitor aberrant behavior, check backgrounds, audit regularly), I would definitely raise awareness amongst my employees of the topic of embezzlement. I think directing them to services like my campaign, as well as others, will help serve as some form of a deterrence, in the least because they’ll know that the owner is not oblivious to the issue.

Success

Many times our unethical behavior may be driven by our need to succeed. But, how do you measure success? Whether it be "climbing the corporate ladder" or "adding another zero," to our salary, how much fame or fortune does a person really need to feel successful?

Case Study

On March 10, 2009, a Criminal Information Complaint was filed in Manhattan federal court charging Bernard L. Madoff with eleven felony charges including securities fraud, investment adviser fraud, mail fraud, wire fraud, three counts of money laundering, false statements, perjury, false filings with the United States Securities and Exchange Commission (SEC), and theft from an employee benefit plan. There was no plea agreement between the Government and the defendant. On March 12, 2009, Madoff pleaded guilty to all eleven counts in the Information. On June 29, 2009, Madoff was sentenced by Judge Chin to a term of imprisonment of 150 years.

David G. Friehling, the CPA who performed audit services for Madoff, pleaded guilty November 3, 2009 to nine criminal charges carrying a potential prison term of 114 years. Among the charges are securities fraud, investment advisor fraud, making false filings with the SEC and obstructing or impeding the administration of the Internal Revenue Office (IRS). At 49 years old, having a wife and three children, Friehling's career as a CPA is over.

According to court documents[6], from 1991 through 2009, Friehling worked as a sole proprietor at the firm Friehling and Horowitz, CPAs. Jerome Horowitz (Friehling's father-in-law) is reported to have retired in or around 1991, and Friehling was the only employee of the firm since that time.

[6] U.S. Justice Department Guilty Plea Transcript, November 3, 2009, http://www.justice.gov/usao/nys/madoff/friehling20091103guiltypleatranscript.pdf, retrieved on October 26, 2010

Although he had no staff to assist him, for 17 years Friehling's firm was retained by Madoff Investment Securities to audit its financial statements that were filed with the SEC. Friehling also stated in court that prior to his retiring, his father-in-law, Jerome Horowitz, was the auditor for Madoff Investment Securities. Horowitz also occasionally assisted Friehling, according to his testimony, in conducting the audit for Madoff Investment Securities after he retired and until 1998.Horowitz passed away from cancer, on March 12th 2009, on the day Madoff pleaded guilty.

Although he received a monthly retainer throughout the 17 years, the courts found that Friehling never once actually performed a meaningful audit of Madoff Investment Securities (i.e., he did not verify any of the information provided to him by Madoff). Yet, over the 17 years, he issued numerous reports stating that he had done so and issued unqualified opinions regarding those financial statements.

In addition, the courts found that Friehling also had a conflict of interest and was therefore not independent of Madoff Investment Securities. Friehling and his family members all had investment advisory accounts at Madoff Investment Securities. Friehling's investments exceeded $500,000 according to his testimony. No disclosure of this fact was ever made in Friehling's reports.

Friehling also plead guilty to aiding and abetting a device, scheme or artifice to defraud. This charge resulted due to the evidence that the courts found which they believe proved that Friehling knew at the time he certified the financial statements that they were materially false, but nevertheless issued an opinion that they were fair and accurate.

As these statements were filed with the SEC and investors of Madoff Investment Securities relied upon these statements to make investment decisions, Friehling was also charged and plead guilty to securities fraud, investment advisor fraud and making false filings with the SEC.

Finally, Friehling pled guilty to impeding the administration of the IRS laws. From 1991 through 2008, Friehling assisted in the preparation of numerous false tax returns, with corrupt intent, for Madoff as well as others according to the courts.

While Friehling still maintains that he knew nothing of Madoff's engagement in a Ponzi scheme, in his testimony to the court he stated:

"In what is surely the biggest mistake of my life I placed my trust in Bernard Madoff."

Do you think that the biggest mistake that Friehling made was putting his trust in Madoff? If not, what do you think was his biggest mistake?

Friehling is free on a 2.5 million bond and was originally scheduled to be sentenced on March 18, 2011.

A successful CPA, with a wife and three kids, compromised his core values of integrity, objectivity and independence for what he perhaps believed would make him even more successful. Will he now instead spend the rest of his life behind bars?

A Personal Sacrifice Case Study

Nominated as one of Time Magazine's *People of the Year 2002*, Sherron Watkins, a former Vice President of Enron, knows personal sacrifice for the sake of ethics. By sending an anonymous e-mail (see Appendix A for a copy of the e-mail) to former Enron CEO, Kenneth Lay, Sherron knew that her life would never be the same. Little did she know at that time, however, how much it would change not only her life, but many more lives.

After beginning her career with Arthur Andersen, Sherron decided to change jobs and began working for Enron in 1993. It wasn't long after that she realized that accounting at Enron had a tendency to deviate from standard accounting practices and had gone "beyond creative to aggressive." She attempted to bring attention to this fact to her superiors, "But I got nowhere," she says. At one point she even confronted former colleagues of hers from Andersen and asked them when they were going to "grow some balls and stop us." She was then reported to her superior, Andrew Fastow, Enron's Chief Financial Officer, who told her to keep her nose out of it.

After changing divisions a few times, Sherron ended up working for Andrew Fastow again in 2001. By the summer of 2001, Sherron could no longer accept looking the other way, when she discovered "an elaborate accounting hoax." Enron had been fraudulently concealing debt from its stockholders by concocting schemes which kept the debt from appearing on its balance sheet.

"When I found the fraud, my first thought was, I've got to get out of here. But as the main breadwinner of my family, I decided to find another job first and then confront Jeff Skilling [then Enron chief executive officer]. Problem is, Jeff Skilling beat me to the punch and quit."

It was the next day, August 15, 2001, when Sherron decided to send a memo to Kenneth Lay regarding her concerns. She originally sent it anonymously, but admitted to being its source the next day. After meeting with Kenneth, Sherron realized that "In hindsight, Ken Lay didn't want to hear what I had to say," she says. "That's pretty much the last I saw of him," Watkins says.

Within a very short period of time after that, Enron stock plummeted. "October 16 was when Enron announced their rather questionable write-offs," Watkins says. "The stock was trading at $33 a share and within six weeks it was at 9 cents a share and the company was declaring bankruptcy on December 2. On December 3 – I call it black Monday – nearly five thousand employees were summoned to these floor meetings and told: 'I hate to tell you this but last Friday was your last paycheck' and that is when the congressional inquiries began." By January 14th, while going through subpoenaed Enron documents, the House Energy and Commerce Committee uncovered Sherron's memo. It was quickly leaked to the press and by the next morning, Sherron and her family awoke to camera crews at their home.

"I got panicky and shaky – the reporters were like an invading army. It was very unnerving. That's when I opened my Bible for comfort. I happened to open to Hebrews 12:1-3: 'Since we are surrounded by such a great cloud of witnesses, let us throw off everything that hinders and the sin that so easily entangles, and let us run with perseverance the race marked out for us. Let us fix our eyes on Jesus … so that you will not grow weary and lose heart,'" explains Sherron. "When you know you're going to be in heaven with your Maker one day, you think about doing what's right – not what you can get away with," adds Sherron. "There's no hiding from God. That belief is what kept me from falling into a corporate culture that outwardly encouraged individuals to display respect and integrity while encouraging them to compromise whenever it was expedient, rationalizing the compromise because everyone else does it."

While preparing for the House Energy and Commerce Committee meeting, Sherron learned that after she had spoken to Kenneth Lay, he had attempted to get her fired. Apparently the attorneys for Enron had warned against this due to the fear that she would file a wrongful termination lawsuit and her concerns about the accounting practices would become public knowledge.

Sherron's original memo to Kenneth Lay stated: "My eight years of Enron work history will be worth nothing on my résumé; the business world will consider my past successes as nothing but an elaborate accounting hoax." Sherron did ultimately have to leave Enron after it filed bankruptcy in 2002, as did thousands of other Enron and affiliated employees. She is now earning her income as a writer and public speaker.

Even though she dedicated her book to the memory of Arthur Andersen, she is angry that the US firm lost its ethics, too. "I joined Andersen in 1982 and it really was the holy grail of good accounting and good auditing," she says. "That's the Andersen I knew and if you talk to any old-time Andersen people they all have some local office story of how they all stood by their accounting principles and turned away a client or dropped a client. I was proud to work there. Then 16 years later it came out in their trial that in February 2001 Andersen had a meeting about the company and it considered Enron its riskiest worldwide client and considered whether to drop Enron. They decided that it was a $52m a year client and it might one day be a $110m a year client so they decided to just do a really good job and put more people on it but keep it as an audit client. So 16 years later it is deciding money is more important than good accounting – to their ultimate demise."

When speaking of her co-workers who did not help to uncover the schemes, Sherron says, she imagines they struggled to tell when their accounting went from creative to aggressive and, ultimately, to fraudulent. "You're not really taking steps towards the edge of a cliff and being forced to step off," she says. "It's more like you're walking down an eggshell. Each step doesn't look too much different from the one you have just taken. But all of a sudden you've slipped off."

Question to Consider

Was Sherron Watkins partially at fault for the Enron collapse because she did not report what she knew to federal authorities earlier? Some say that she was not in fact a "whistleblower," because it was not until her memo was discovered by federal agencies and she was subpoenaed that she came forth with the truth. Had she come forth sooner, could Enron have been saved? "When a company cooks the books, its best bet is to come clean from inside. If it is exposed from the outside it means almost certain financial ruin. I was hoping Enron would do the right thing. If they had continued the fraud I would almost certainly have considered doing something outside," explains Sherron Watkins.

Largely due to the collapse of Enron and Arthur Andersen’s involvement in consulting them on their accounting practices, at the same time that they were also responsible for their audits, the Sarbanes-Oxley Act of 2002 was passed.

Study Questions

1. The difference between "right" and "wrong" is generally which of the following?
   A. Very clear
   B. Inherited
   C. A set of rules that apply to all humans
   D. A set of rules that no two people would totally agree on

2. The largest part of the prior research projects which have been done on ethical issues in accounting have generally focused on which of the following?
   A. What is "right"
   B. What is "wrong"
   C. What is "bad"
   D. Whether accountants are abiding by the rules of professional conduct

3. Which of the following principles emphasizes maxims, duties, rules, and principles that are so important that they should be followed whatever the consequences?
   A. Utilitarianism
   B. Teleological ethics
   C. Kantian ethics
   D. Utilitarianism and Deontology

Answers to Study Questions

1. A. Incorrect. While on initial thought, one's perception of right and wrong may seem very clear, this is not usually the case in most situations.
   B. Incorrect. Ethics is a science based on a set of rules. Those rules (or the determinations of what is right and wrong) are different for many people even within the same family.
   C. Incorrect. There is no one set of ethical rules that apply to all humans. Rather, there are many sets of rules that apply to various groups.
   D. **Correct.** While the difference between "right" and "wrong" may seem very clear to each of us individually, it is closer to the truth that no two people in the world would agree on the same ethical codes of conduct to define "right" and "wrong."

2. A. Incorrect. Most likely, it would be very difficult for research projects to define what is right for everyone. Ethical rules are, however, defined based on a particular group's definition of what is right.
   B. Incorrect. Most likely, it would be very difficult for research projects to define what is wrong for everyone. Ethical rules are, however, defined based on a particular group's definition of what is wrong.
   C. Incorrect. Most likely, it would be very difficult for research projects to define what is bad for everyone. Ethical rules are, however, defined based on a particular group's definition of what is bad.
   D. **Correct.** Many times, conflicts occur when trying to abide by one code of ethical conduct, without breaking the rules of another. For example, one's religious ethical code may interfere with one's professional code of conduct. This is where ethical reasoning comes into play and it is where the largest part of the prior research projects have been done on ethical issues in accounting.

3. A. Incorrect. Utilitarianism applies the reasoning that the best long-term interest of everyone concerned should be the moral standard.

B. Incorrect. Teleological ethics applies the reasoning that one should take those actions that lead to the greatest balance of good versus bad consequences.
C. **Correct.** Kantian ethics emphasizes maxims, duties, rules, and principles that are so important that they should be followed whatever the consequences.
D. Incorrect. Many times, conflicts occur when trying to abide by one code of ethical conduct, without breaking the rules of another. There are basically two separate principles used to resolve ethical dilemmas, related to CPAs, which are utilitarianism (Teleological ethics) and rule deontology (Kantian ethics).

Chapter 3
Core Values of the CPA Profession

Integrity, objectivity and independence are the core values of the CPA profession. They are discussed in both the TSBPA Rules of Professional Conduct and the AICPA Code of Professional Conduct. When a CPA loses their commitment to these core values, they lose their honor.

"Honor is better than honors." - President Lincoln

Case Study

Founded in 1913 in Chicago, Illinois, Arthur Andersen was an organization that was committed to integrity, objectivity and independence. Its founder, Arthur Andersen, donated more than $5 million dollars to universities for awareness of ethical issues pertaining to business, prior to his death in 1947. Anderson considered ethics to be the backbone of the firm.

After his death, it appears those values were lost, and the greed of corporate officers and its partners led to the scandals associated with WorldCom, Waste Management, and Enron. Now, what was once recognized as one of the top accounting and auditing firms in the nation, Arthur Anderson is a firm that has lost its honor.

Integrity and Objectivity

The Texas Rules of Professional Conduct require integrity and that a person in the performance of professional accounting services or professional accounting work shall maintain integrity and objectivity, shall be free of conflicts of interest and shall not knowingly misrepresent facts nor subordinate his or her judgment to others. In tax practice, however, a person may resolve doubt in favor of his client as long as any tax position taken complies with applicable standards such as those set forth in Circular 230 issued by the Internal Revenue Service and AICPA Statements on Standards for Tax Services.

A conflict of interest may occur if a person performs a professional accounting service or professional accounting work for a client or employer and the person has a relationship with another person, entity, product, or service that could, in the person's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the person's objectivity. If the person believes that the professional accounting service or professional accounting work can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, then this rule shall not operate to prohibit the performance of the professional accounting service or professional accounting work because of a conflict of interest.

Certain professional engagements, such as audits, reviews, and other services, require independence. Independence impairments cannot be eliminated by disclosure and consent.

A person shall not concurrently engage in the practice of public accountancy and in any other business or occupation which impairs independence or objectivity in rendering professional accounting services or professional accounting work, or which is conducted so as to augment or benefit the accounting practice unless these rules are observed in the conduct thereof.

The AICPA Code of Professional Conduct (ET Section 54 Article III) states that: “To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.” Integrity is defined as:

> *“an element of character fundamental to professional recognition. It is the quality from which the public trust derives and the benchmark against which a member must ultimately test all decisions.”*

The Code notes that while integrity requires a CPA to be honest (it cannot accommodate deceit or subordination of principle), it also requires the CPA to recognize the constraints of client confidentiality. In addition, service and the public trust should not be subordinated to personal gain and advantage.

While integrity can be measured in terms of what is right or wrong, objectivity is a state of mind. According to the Code, the principle of objectivity imposes the obligation to be:

- impartial,
- intellectually honest, and
- free of conflicts of interest.

Rule 102 of the Code states that:

"In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others."

A CPA may be considered in violation of this Rule if he or she:

- Makes, or permits or directs another to make, materially false and misleading entries in an entity's financial statements or records.
- Fails to correct an entity's financial statements or records that are materially false and misleading when he or she has the authority to record an entry.
- Signs, or permits or directs another to sign, a document containing materially false and misleading information.

Conflicts of interest should be considered for example when:

- A member has been asked to perform litigation services for the plaintiff in connection with a lawsuit filed against a client of the member's firm.
- A member has provided tax or personal financial planning (PFP) services for a married couple who are undergoing a divorce, and the member has been asked to provide the services for both parties during the divorce proceedings.
- In connection with a PFP engagement, a member plans to suggest that the client invest in a business in which he or she has a financial interest.
- A member provides tax or PFP services for several members of a family who may have opposing interests.
- A member has a significant financial interest, is a member of management, or is in a position of influence in a company that is a major competitor of a client for which the member performs management consulting services.
- A member serves on a city's board of tax appeals, which considers matters involving several of the member's tax clients.
- A member has been approached to provide services in connection with the purchase of real estate from a client of the member's firm.

- A member refers a PFP or tax client to an insurance broker or other service provider, which refers clients to the member under an exclusive arrangement to do so.
- A member recommends or refers a client to a service bureau in which the member or partner(s) in the member's firm hold material financial interest(s).- [Rule 102-2]

Case Study

Working for a company with an outstanding credit line and covenants that are required to be met in order for the line not to become due and payable in full, can always be a challenge for a controller. As the person in charge of reporting the financials, Sue Smith found herself in uncomfortable situations various times with this issue particularly with one company. Our biggest problem was our accounts receivable balance, Sue explains.

In the industry of providing training workshops, our contracts specifically stated the dates of the workshops and that in the event the workshop was cancelled by the client, the full amount of the contract would be due in full (a no cancellation policy).

The problem was that many of the contracts stating this policy were not being signed by the client. Although there were verbal agreements that this was the cancellation policy, without a written agreement, Sue did not feel it was appropriate to accrue the revenue on the financials. However, if she did not, it could mean that the line of credit would become due and payable as the company depended on the accounts receivable balance to meet their current ratio covenant. The owners may even fire Sue if that happened. She felt she would let her company and all of its employees down if she did not do her best to meet the covenant requirements. Or would she? It wasn't her responsibility to make sure the contracts got signed by the clients? Her responsibility was to report accurate and timely financial information. Sue finally decided that she could not report on a contract that was not signed.

What would you do?

Sue refused to accrue the revenue on contracts that were not signed. Yes, there were some complaints in the beginning, but thanks to the fax machine and a few fast moving sales representatives and clients, they were always able to get a signed copy when they needed it. Sue also noticed that fewer and fewer unsigned contracts existed and the board of directors seemed to have much more faith in her ability to control the financial processes.

Independence

Upholding integrity and objectivity values calls for avoiding both actual and apparent conflicts of interest. This is also referred to as being independent both in fact and in appearance.

> **Independence of mind.** The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.
>
> **Independence in appearance.** The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised. [ET Section 100.01]

The Texas Rules of Professional Conduct require that all CPAs, whether they are members of the AICPA or not, conform in fact and in appearance to the independence standards established by the AICPA and the Board, and, where applicable, the U.S. Securities and Exchange Commission, the General Accounting Office and other regulatory or professional standard setting bodies.

"Covered members" are required to comply with the independence rules under the AICPA Code of Professional Conduct. Covered members include:

1) An individual on the client's attest engagement team
2) An individual in a position to influence the client's attest engagement
3) A partner or manager who provides more than 10 hours of nonattest services to the attest client
4) A partner in the office in which the lead attest engagement partner primarily practices in connection with the client's attest engagement

5) The firm, including the firm's employee benefit plans
6) An entity whose operating, financial, or accounting policies can be controlled by any of the individuals or entities described in items 1–5 or by two or more such individuals or entities if they act together

Exception: The Code prohibits these relationships if you are a partner or professional employee in a public accounting firm, <u>even if you are not a covered member</u>:

- Director, officer, or employee (or in any capacity equivalent to a member of management) of the client, promoter, underwriter, voting trustee, or trustee of any of the client's employee benefit plans
- Owner of more than 5 percent of an attest client's outstanding equity securities (or other ownership interests)

ET Section 100, Independence, of the AICPA Code of professional Conduct requires the following in respect to a CPA's independence when performing an attest engagement:

- A member should consult the rules of his or her state board of accountancy, his or her state CPA society:
    - If the members report will be filed with the U.S. Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB) and the SEC rules should also be reviewed.
    - If the member's report will be filed with the U.S. Department of Labor (DOL), the DOL rules should be reviewed.
    - If law, regulation, agreement, policy or contract requires the member's report to be filed under the Government Accountability Office (GAO) regulations, the GAO rules should be reviewed.
    - Any other organization that issues or enforces standards of independence that would apply to the member's engagement should also be reviewed. Such organizations may have independence requirements or rulings that differ from (e.g., may be more restrictive than) those of the AICPA.

Also understanding that it is impossible to address all potential independence conflicts which may occur, the AICPA requires that accountants use the risk-based approach to address matters which are not specifically discussed in the Code.

Risk-Based Approach to Independence

Applying the risk-based approach when determining independence generally means that when threats to independence are not at an acceptable level, safeguards must be applied to eliminate the threats or reduce them to an acceptable level. In cases when threats to independence are not at an acceptable level, and thereby require the application of safeguards, the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level must be documented.

ET Section 100-1, *Conceptual Framework for AICPA Independence Standards*, details the requirements of the risk-based approach to analyzing independence matters, as summarized below.

Steps Required Under the Risk-Based Approach to Independence

(1) **Identify and evaluate threats to independence –** Identify and evaluate threats, both individually and in the aggregate, because threats can have a cumulative effect on a member's independence. Where threats are identified but, due to the types of threats and their potential effects, such threats are considered to be at an acceptable level (that is, it is not reasonable to expect that the threats would compromise professional judgment), the consideration of safeguards is not required. If identified threats are not considered to be at an acceptable level, safeguards should be considered.

(2) **Determining whether safeguards already eliminate or sufficiently mitigate identified threats and whether threats that have not yet been mitigated can be eliminated or sufficiently mitigated by safeguards –** Different safeguards can mitigate or eliminate different types of threats, and one safeguard can mitigate or eliminate several types of threats simultaneously. When threats are sufficiently mitigated by safeguards, the threats' potential to compromise professional judgment is reduced to an acceptable level. A threat has been sufficiently

mitigated by safeguards if, after application of the safeguards, it is not reasonable to expect that the threat would compromise professional judgment.

> **Note:** In cases where threats to independence are not at an acceptable level, thereby requiring the application of safeguards, the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level should be documented as required under "Other Considerations" of Interpretation 101-1, Interpretation of Rule 101 [ET section 101.02].

(3) If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered impaired.

Definitions

- **Impair –** For purposes of this framework, impair means to effectively extinguish (independence). When a member's independence is impaired, the member is not independent.
- **Threats** – Threats to independence are circumstances that could impair independence. Whether independence is impaired depends on the nature of the threat, whether it would be reasonable to expect that the threat would compromise the member's professional judgment and, if so, the specific safeguards applied to reduce or eliminate the threat, and the effectiveness of those safeguards.
- **Safeguards –** Controls that mitigate or eliminate threats to independence. Safeguards range from partial to complete prohibitions of the threatening circumstance to procedures that counteract the potential influence of a threat. The nature and extent of the safeguards to be applied depend on many factors, including the size of the firm and whether the client is a public interest entity. To be effective, safeguards should eliminate the threat or reduce to an acceptable level the threat's potential to impair independence.

Categories of Threats

(1) **Self-review –** Members reviewing as part of an attest engagement evidence that results from their own, or their firm's, nonattest work such as preparing source documents used to generate the client's financial statements

(2) **Advocacy –** Actions promoting an attest client's interests or position.
   a. Promoting the client's securities as part of an initial public offering
   b. Representing a client in U.S. tax court

(3) **Adverse interest –** Actions or interests between the member and the client that are in opposition, such as, commencing, or the expressed intention to commence, litigation by either the client or the member against the other.

(4) **Familiarity –** Members having a close or longstanding relationship with an attest client or knowing individuals or entities (including by reputation) who performed nonattest services for the client.
   a. A member of the attest engagement team whose spouse is in a key position at the client, such as the client's chief executive officer
   b. A partner of the firm who has provided the client with attest services for a prolonged period
   c. A member who performs insufficient audit procedures when reviewing the results of a nonattest service because the service was performed by the member's firm
   d. A member of the firm having recently been a director or officer of the client
   e. A member of the attest engagement team whose close friend is in a key position at the client

(5) **Undue influence –** Attempts by an attest client's management or other interested parties to coerce the member or exercise excessive influence over the member.
   a. A threat to replace the member or the member's firm over a disagreement with client management on the application of an accounting principle
   b. Pressure from the client to reduce necessary audit procedures for the purpose of reducing audit fees
   c. A gift from the client to the member that is other than clearly insignificant to the member

(6) **Financial self-interest –** Potential benefit to a member from a financial interest in, or from some other financial relationship with, an attest client.
   a. Having a direct financial interest or material indirect financial interest in the client
   b. Having a loan from the client, from an officer or director of the client, or from an individual who owns 10 percent or more of the client's outstanding equity securities
   c. Excessive reliance on revenue from a single attest client
   d. Having a material joint venture or other material joint business arrangement with the client

(7) **Management participation –** Taking on the role of client management or otherwise performing management functions on behalf of an attest client.
   a. Serving as an officer or director of the client
   b. Establishing and maintaining internal controls for the client
   c. Hiring, supervising, or terminating the client's employees

Categories of Safeguards

(1) **Safeguards created by the profession, legislation, or regulation –** Examples include but are not limited to education and training requirements on independence and ethics rules for new professionals, professional standards and monitoring and disciplinary processes, external review of a firm's quality control system, legislation governing the independence requirements of the firm, and competency and experience requirements for professional licensure.

(2) **Safeguards implemented by the attest client –** Examples include but are not limited to safeguards such as the attest client has personnel with suitable skill, knowledge, and/or experience who make managerial decisions with respect to the delivery of nonattest services by the member to the attest client or a tone at the top that emphasizes the attest client's commitment to fair financial reporting.

(3) **Safeguards implemented by the firm, including policies and procedures to implement professional and regulatory requirements –** Examples include but are not limited to safeguards such as firm leadership that stresses the importance of independence and the expectation that members of attest engagement teams will act in the public interest or policies and procedures that are designed to implement and monitor quality control in attest engagements.

Understanding the ever changing and complex environment that CPAs who perform attest services are practicing in today, the AICPA has published a checklist to simplify compliance with both the AICPA and GAO rules. The checklist, *Independence Compliance: Checklists and Tools for Complying With AICPA and GAO Independence Requirements, Second Edition,* can be purchased online at www.cpa2biz.com.

Case Study – Performance of Nonattest Services (Interpretation 101-3)

The following is a case study reported in the Journal of Accountancy (December, 2007) illustrating independence issues when performing nonattest services.

Construct Inc. is a small, family-owned-and-managed construction company that provides services to residential and commercial customers. The company employs George, an accountant who maintains the books and records, is familiar with GAAP and can prepare the financial statements. Because of a shortage of internal resources to do the work, Construct engaged its practitioner to help process the company's payroll. George oversaw the services in which the practitioner:

- ♦ Used approved timecards and other client records to calculate the payroll and generate unsigned checks for the client's signature.
- ♦ Transmitted payroll data to the client's financial institution (pre-authorized by the client).
- ♦ Submitted electronic payroll tax payments in accordance with U.S. Treasury Department and other relevant jurisdictions' guidelines under arrangements made with the client and its financial institution.

In accordance with Interpretation 101-3, George assumed all management responsibilities for the practitioner's services. He also performed control activities related to payroll. These duties included spot-checking the payroll for accuracy by recalculating the payroll for select employees and comparing his amounts to those the practitioner calculated, reviewing disbursements to gauge consistency with prior periods and investigating any inconsistencies. The practitioner considered George capable of overseeing the payroll work for independence purposes.

However, during the audit, the practitioner identified a significant deficiency in internal control over financial reporting. He learned that George misclassified payroll expense between contracts when posting the job cost ledger. This would have caused a misstatement in the financial statements.

Does the practitioner's identification of a significant deficiency or material weakness in internal control over financial reporting in an area in which he or she previously performed nonattest services impair independence?

The test for independence when the practitioner performs nonattest services is whether he or she complied with Interpretation 101-3. Under that rule, Construct Inc. and the practitioner agreed to the responsibilities that each would undertake in connection with the payroll services engagement. This ensured that the practitioner would not assume management's responsibilities for the payroll process. Therefore, the fact that the practitioner concluded during the audit that a significant deficiency (or even a material weakness) in ICFR existed does not mean that independence was impaired when the payroll services were performed.

The Sarbanes-Oxley Act of 2002

On July 30, 2002 President George W. Bush signed into law the Sarbanes-Oxley Act (SOX) of 2002. SOX, which applies in general to publicly held companies and their audit firms, dramatically affects the accounting profession and impacts not just the largest accounting firms, but any CPA actively working as an auditor of, or for, a publicly traded company.

While this course will not detail all of the provisions of SOX, it is important to make note of some of the more pertinent provisions which you should be aware of as a practicing CPA.

Probably one of the most important provisions of SOX was the establishment of the Public Company Accounting Oversight Board (PCAOB). The PCAOB was directed to perform the following tasks:

1) Register public accounting firms;

2) Establish, or adopt by rule, "auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers;"
3) Conduct inspections of accounting firms;
4) Conduct investigations and disciplinary proceedings, and impose appropriate sanctions;
5) Perform such other duties or functions as necessary or appropriate;
6) Enforce compliance with the Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto;
7) Set the budget and manage the operations of the Board and the staff of the Board.

The following is a recap (as modified from an AICPA summary on their website at www.aicpa.org) of some of the other regulations under SOX:

Section 104: Inspections of Registered Public Accounting Firms

Annual quality reviews (inspections) must be conducted for firms that audit more than 100 issues; all others must be conducted every 3 years. The SEC and/or the Board may order a special inspection of any firm at any time.

Section 201: Services Outside the Scope of Practice of Auditors; Prohibited Activities.

It is "unlawful" for a registered public accounting firm to provide any non-audit service to an issuer contemporaneously with the audit, including:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;

- Broker or dealer, investment adviser, or investment banking services;
- Legal services and expert services unrelated to the audit;
- Any other service that the Board determines, by regulation, is impermissible.

The Board may, on a case-by-case basis, exempt from these prohibitions any person, issuer, public accounting firm, or transaction, subject to review by the Commission.

It will not be unlawful to provide other non-audit services if they are pre-approved by the audit committee in the following manner. The bill allows an accounting firm to "engage in any non-audit service, including tax services," that is not listed above, only if the activity is pre-approved by the audit committee of the issuer. The audit committee will disclose to investors in periodic reports its decision to pre-approve non-audit services. Statutory insurance company regulatory audits are treated as an audit service, and thus do not require pre-approval.

The pre-approval requirement is waived with respect to the provision of non-audit services for an issuer if the aggregate amount of all such non-audit services provided to the issuer constitutes less than 5% of the total amount of revenues paid by the issuer to its auditor (calculated on the basis of revenues paid by the issuer during the fiscal year when the non-audit services are performed); such services were not recognized by the issuer at the time of the engagement to be non-audit services; and such services are promptly brought to the attention of the audit committee and approved prior to completion of the audit.

The authority to pre-approve services can be delegated to one or more members of the audit committee, but any decision by the delegate must be presented to the full audit committee.

Section 203: Audit Partner Rotation.

The lead audit or coordinating partner and the reviewing partner must rotate off of the audit every 5 years.

Section 206: Conflicts of Interest.

The CEO, Controller, CFO, Chief Accounting Officer or person in an equivalent position cannot have been employed by the company's audit firm during the 1-year period preceding the audit.

Section 302: Corporate Responsibility for Financial Reports.

The CEO and CFO of each issuer shall prepare a statement to accompany the audit report to certify the “appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer.” A violation of this section must be knowing and intentional to give rise to liability.

Section 305: Officer and Director Bars and Penalties; Equitable Relief.

If an issuer is required to prepare a restatement due to “material noncompliance” with financial reporting requirements, the chief executive officer and the chief financial officer shall “reimburse the issuer for any bonus or other incentive-based or equity-based compensation received” during the twelve months following the issuance or filing of the non-compliant document and “any profits realized from the sale of securities of the issuer” during that period.

In any action brought by the SEC for violation of the securities laws, federal courts are authorized to “grant any equitable relief that may be appropriate or necessary for the benefit of investors.”

Section 306: Insider Trades During Pension Fund Black-Out Periods Prohibited.

This section prohibits the purchase or sale of stock by officers and directors and other insiders during blackout periods. Any profits resulting from sales in violation of this section “shall inure to and be recoverable by the issuer.” If the issuer fails to bring suit or prosecute diligently, a suit to recover such profit may be instituted by “the owner of any security of the issuer.”

Section 402(a): Prohibition on Personal Loans to Executives.

Generally, it will be unlawful for an issuer to extend credit to any director or executive officer. Consumer credit companies may make home improvement and consumer credit loans and issue credit cards to its directors and executive officers if it is done in the ordinary course of business on the same terms and conditions made to the general public.

Section 403: Disclosures of Transactions Involving Management and Principal Stockholders.

Directors, officers, and 10% owners must report designated transactions by the end of the second business day following the day on which the transaction was executed.

Section 404: Management Assessment of Internal Controls.

Requires each annual report of an issuer to contain an "internal control report," which shall:

1) State the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
2) Contain an assessment, as of the end of the issuer's fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

Each issuer's auditor shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this section shall be in accordance with standards for attestation engagements issued or adopted by the Board. An attestation engagement shall not be the subject of a separate engagement.

The language in the report of the Committee which accompanies the bill to explain the legislative intent states, "—the Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees."

Directs the SEC to require each issuer to disclose whether it has adopted a code of ethics for its senior financial officers and the contents of that code.

Directs the SEC to revise its regulations concerning prompt disclosure on Form 8-K to require immediate disclosure "of any change in, or waiver of," an issuer's code of ethics.

Title VIII: Corporate and Criminal Fraud Accountability Act of 2002.

It is a felony to "knowingly" destroy or create documents to "impede, obstruct or influence" any existing or contemplated federal investigation.

Auditors are required to maintain "all audit or review work papers" for five years.

The statute of limitations on securities fraud claims is extended to the earlier of five years from the fraud, or two years after the fraud was discovered, from three years and one year, respectively.

Employees of issuers and accounting firms are extended "whistleblower protection" that would prohibit the employer from taking certain actions against employees who lawfully disclose private employer information to, among others, parties in a judicial proceeding involving a fraud claim. Whistleblowers are also granted a remedy of special damages and attorney's fees.

A new crime for securities fraud that has penalties of fines and up to 10 years imprisonment.

Title IX: White Collar Crime Penalty Enhancements

Maximum penalty for mail and wire fraud increased from 5 to 10 years.

Creates a crime for tampering with a record or otherwise impeding any official proceeding.

SEC given authority to seek court freeze of extraordinary payments to directors, offices, partners, controlling persons, agents or employees.

U.S. Sentencing Commission to review sentencing guidelines for securities and accounting fraud.

SEC may prohibit anyone convicted of securities fraud from being an officer or director of any publicly traded company.

Financial statements filed with the SEC must be certified by the CEO and CFO. The certification must state that the financial statements and disclosures fully comply with provisions of the Securities Exchange Act and that they fairly present, in all material respects, the operations and financial condition of the issuer. Maximum penalties for willful and knowing violations of this section are a fine of not more than $500,000 and/or imprisonment of up to 5 years.

Section 1102: Tampering With a Record or Otherwise Impeding an Official Proceeding

Makes it a crime for any person to corruptly alter, destroy, mutilate, or conceal any document with the intent to impair the object's integrity or availability for use in an official proceeding or to otherwise obstruct, influence or impede any official proceeding is liable for up to 20 years in prison and a fine.

Study Questions

1. Which of the following is <u>not</u> one of the core values of the CPA profession as discussed in this course?
   A. Honor
   B. Objectivity
   C. Integrity
   D. Independence

2. The AICPA Code of Professional Conduct (ET Section 54 Article III) states that: "To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of.." which of the following?
   A. Honor
   B. Objectivity
   C. Integrity
   D. Independence

3. According to the *Conceptual Framework for AICPA Independence Standards,* which of the following means to effectively extinguish independence?
   A. Threats
   B. Safeguards
   C. Impair
   D. Ethics

4. Which of the following services is <u>not</u> prohibited under Title II of the Sarbanes-Oxley Act of 2002 outside the scope of practice of auditors?
   A. Bookkeeping services
   B. Actuarial services
   C. Tax compliance with pre-approval from the board
   D. Implementation of financial information systems

Answers to Study Questions

1. A. **Correct.** Honor is obtained by adhering to the core principles and values.
   B. Incorrect. A CPA's ability to remain objective is required when performing all engagements according to the AICPA.
   C. Incorrect. A CPA must perform with integrity as it is the benchmark on which all decisions should be based.
   D. Incorrect. Independence in both fact and appearance is a core value.

2. A. Incorrect. Honor is obtained by adhering to the core principles and values.
   B. Incorrect. A CPA's ability to remain objective is required when performing all engagements according to the AICPA.
   C. **Correct.** A CPA must perform with integrity as it is the benchmark on which all decisions should be based and in which public trust is derived.
   D. Incorrect. Independence in both fact and appearance is a core value.

3. A. Incorrect. Threats to independence are circumstances that could impair independence.
   B. Incorrect. Safeguards are controls that mitigate or eliminate threats to independence.
   C. **Correct.** When a CPA's independence is impaired, they are no longer considered to be independent.
   D. Incorrect. Ethics is a science.

4. A. Incorrect. Bookkeeping and appraisal or valuation services are specifically prohibited under Title II of the Sarbanes-Oxley Act of 2002 outside the scope of practice of auditors.
   B. Incorrect. Actuarial services and legal services are specifically prohibited under Title II of the Sarbanes-Oxley Act of 2002 outside the scope of practice of auditors.
   C. **Correct.** Firms may provide tax services (including tax planning and tax compliance) or others that are not listed, provided the firm receives pre-approval from the board. However, certain tax planning products, like tax avoidance services, may be considered prohibited nonaudit services.

D. Incorrect. Design and implementation of financial information systems as well as investment or broker services are specifically prohibited under Title II of the Sarbanes-Oxley Act of 2002 outside the scope of practice of auditors.

Chapter 4
AICPA Code of Professional Conduct

This part of the course covers the AICPA's *Code* of *Professional Conduct, Statements on Standards for Consulting Services*, and the disciplinary systems within the accounting profession.

The AICPA *Code of Professional Conduct* consists of ethical principles and specific rules.

Ethical Principles

The ethical principles section of the AICPA *Code of Professional Conduct* consists of six ideal standards of ethical behavior required of CPAs by the AICPA as follows:

1. **Responsibilities** – CPAs should exercise sensitive professional and moral judgments when carrying out their professional responsibilities.
2. **The Public Interest** – CPAs should act to benefit the public interest, honor the public trust, and demonstrate commitment to professionalism.
3. **Integrity** – CPAs should perform their professional responsibilities with the highest sense of integrity to maintain public confidence.
4. **Objectivity and Independence** – A CPA should maintain objectivity and be free of conflicts of interest. A CPA in public practice should be independent in fact and appearance when providing audit and other attestation services..
5. **Due Care** – A CPA should follow the profession's technical and ethical standards, strive for improved competence and quality services, and discharge professional responsibility to the best of their ability.
6. **Scope and Nature of Services** – A member in public practice should follow the Principles of the *Code of Professional Conduct* in determining the nature and scope of services.

Specific Rules

The remainder of the AICPA *Code of Professional Conduct* consists of a breakdown of specific rules which define minimum standards of ethical conduct for CPAs. The following is a brief summary of those rules.

Rule 101 – *Independence.* A CPA in public practice should be independent when performing professional services as required by standards-setting bodies.

Rule 102 – *Integrity and Objectivity.* A member shall maintain objectivity and integrity, be free of conflicts of interest, not knowingly misrepresent facts, and not subordinate his/her judgment to others when performing professional services.

Rule 201 – *General Standards.* A CPA must comply with the following:

1) Undertake only those services that the CPA or the CPA's firm can reasonably expect to complete with professional competence.
2) Exercise due professional care when performing professional services.
3) Adequately plan and supervise performance of professional services.
4) Obtain sufficient relevant data to provide a reasonable basis for conclusions in relation to any professional service.

Rule 202 – *Compliance with Standards.* A CPA who performs professional services must comply with promulgated standards.

Rule 203 – *Accounting Principles.* A CPA should not express an opinion or make an affirmative statement about conformity with GAAP or state that (s)he is not aware of any material modifications that should be made to achieve conformity with GAAP, given any departure from an accounting principle promulgated by bodies designated by the AICPA Council to establish such principles that has a material effect on the financial statements or data taken as a whole. However, if the CPA can demonstrate that, due to unusual circumstances, the financial statements or data would have been misleading without a departure from GAAP, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons compliance with the principle would be misleading.

Rule 301 – *Confidential Client Information.* A CPA in public practice cannot disclose confidential client information without the client's consent. However, this Rule does not affect a CPA's obligations:

- To comply with a validly issued and enforceable subpoena or summons or with applicable laws and regulations

- To discharge his/her professional obligations properly under Conduct Rules 202 and 203
- To cooperate in a review of the CPA's professional practice under AICPA or state CPA society or board of accountancy authorization
- To initiate a complaint with or respond to any inquiry made by the professional ethics division, trial board of the AICPA, or an investigative or disciplinary body of a state society or board of accountancy

Rule 302 – *Contingent Fees.* A contingent fee is established as part of an agreement under which the amount of the fee is dependent upon the finding or result.

1) The receipt of contingent fees by a CPA is prohibited when the CPA performs an audit, a review, or a compilation when the report will be used by third parties and the report does not disclose the CPA's lack of independence, or an examination of prospective financial information
2) A contingent fee is not permitted for preparing an original or amended tax return or claim.
3) Fees are not deemed to be contingent if fixed by courts or other public authorities, or in tax matters, if they are based on the results of judicial proceedings or the findings of governmental agencies.

Rule 501 – *Acts Discreditable.* A CPA should not commit an act that is discreditable to the profession.

Rule 502 – *Advertising and Other Forms of Solicitation.* A CPA in public practice should not seek to obtain clients by advertising or other forms of solicitation done in a false, misleading, or deceptive manner. Solicitation through coercion, overreaching, or harassing conduct is prohibited.

Rule 503 – *Commissions and Referral Fees.* A CPA in public practice should not accept a commission for recommending or referring to a client any product or service, or for recommending or referring any product or service to be supplied by a client, if the CPA performs for that client an audit, a review, or a compilation when a third party will use the financial statement and the report does not disclose the CPA's lack of independence, or an examination of prospective financial information.

1) Permitted commissions must be disclosed to any person or entity to whom the member recommends a product or service.
2) A CPA who accepts a referral fee for recommending services of a CPA or who pays a referral fee to obtain a client must disclose the arrangement to the client. A referral fee is compensation for recommending or referring any service of a CPA to any person. Referral fees are not considered commissions.

Rule 505 – *Form of Organization and Name.* A CPA may practice public accounting only in a form of organization allowed by law or regulation that conforms with resolutions of the AICPA Council.

1) The CPA firm name may not be misleading.
2) Names of past owners may be included in the name of the successor organization.
3) A firm cannot designate itself as "members of the AICPA" unless all of its CPA owners are members of the AICPA.

Study Questions

1. Which of the following statements best explains why the CPA profession has found it essential to promulgate ethical standards and to establish means for ensuring their observance?
   A. A distinguishing mark of a profession is its acceptance of responsibility to the public.
   B. A requirement for a profession is to establish ethical standards that stress primarily a responsibility to clients and colleagues.
   C. Ethical standards that emphasize excellence in performance over material rewards establish a reputation for competence and character.
   D. Vigorous enforcement of an established code of ethics is the best way to prevent unscrupulous acts.

2. The appearance of independence of a CPA is most likely to be impaired if the CPA does which of the following?
   A. Provides appraisal, valuation, or actuarial services for an attest client.
   B. Joins a trade association, which is an attest client, and serves in a nonmanagement capacity.
   C. Accepts a token gift from an attest client.
   D. Serves as an executor and trustee of the estate of an individual who owned the majority of the stock of a closely held client corporation.

3. The AICPA Code of Professional Conduct states, in part, that a CPA should maintain integrity and objectivity. Objectivity in the Code refers to a CPA's ability to do which of the following?
   A. To maintain an impartial attitude on all matters that come under the CPA's review.
   B. To independently distinguish between accounting practices that are acceptable and those that are not.
   C. To be unyielding in all matters dealing with auditing procedures.
   D. To independently choose between alternate accounting principles and auditing standards.

4. A violation of the profession's ethical standards would most likely have occurred when a CPA did which of the following?
    A. Made arrangements with a bank to collect notes issued by a client in payment of fees due.
    B. Joined an accounting firm made up of three non-CPA practitioners.
    C. Expressed an unqualified opinion on the year 2 financial statements when fees for the year 1 audit were unpaid.
    D. Purchased a bookkeeping firm's practice of monthly write-ups for a percentage of fees received over a 3-year period.

5. To exercise due professional care, an auditor should do which of the following?
    A. Exercise professional skepticism.
    B. Examine all available corroborating evidence supporting management's assertions.
    C. Design the audit to detect all instances of fraud.
    D. Attain the proper balance of professional experience and formal education.

6. AICPA Conduct Rule 301, Confidential Client Information, is violated when a member in public practice does which of the following?
    A. Provides client profit and loss percentages to a trade association without the client's consent.
    B. Uses outside computer services to process tax returns.
    C. Performs consulting services for similar clients.
    D. Advises potential consulting services clients about previous problems on similar engagements.

7. Conduct Rule 501 states that a member shall not commit an act discreditable to the profession. Which of the following would <u>not</u> be considered such an act?
    A. After the relationship of a member who is not an owner of the firm is terminated, the member takes copies from the firm's client files without permission.
    B. Retention of a client's records after a demand is made for them in a state that specifically grants the CPA a lien on all client records.

C. Withholding as a result of nonpayment of fees for a completed engagement certain information contained in the client's books.
D. Failure to provide the client with client records that are part of the working papers.

Answers to Study Questions

1. A. **Correct.** According to Article II of the Principles section of the AICPA Code of Professional Conduct, "Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism." According to the accompanying explanation, "A distinguishing mark of a profession is acceptance of its responsibility to the public."
   B. Incorrect. The responsibility of CPAs is to a public that is not limited to clients and colleagues but includes all those who rely on their objectivity and integrity.
   C. Incorrect. Excellence in performance is but one of the effects of accepting responsibility to the public.
   D. Incorrect. Vigorous enforcement is significant but secondary to the creation of an environment in the profession that fosters voluntary adherence to ethical principles.

2. A. Incorrect. Independence is not necessarily impaired if the CPA does not perform management functions or make management decisions, if all significant matters of judgment are determined or approved by the client, and the client is in a position to make an informed judgment.
   B. Incorrect. Independence is not impaired, provided the CPA does not participate in management.
   C. Incorrect. A token gift will not impair independence. However, a CPA who accepts more than a token gift, even with the knowledge of the member's firm, will appear to lack independence.
   D. **Correct.** According to an Interpretation of Conduct Rule 101, independence is impaired if, during the period of the professional engagement, "a covered member was a trustee of any trust or executor or administrator of any estate if such trust or estate had or was committed to acquire any direct or material indirect financial interest in the client." An Ethics Ruling states that mere designation as trustee or executor does not impair independence in the foregoing circumstances but that actual service does.

3. A. **Correct.** According to the Principles, “Objectivity is a state of mind, a quality that lends itself to a member’s services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.”
   B. Incorrect. The CPA uses both judgment and GAAP to evaluate whether a client’s accounting practices are acceptable.
   C. Incorrect. The CPA is expected to use professional judgment, which may include flexibility, in applying audit procedures.
   D. Incorrect. Auditing standards are concerned with the quality of the auditor’s performance, whereas adherence to accounting principles by management is a prerequisite for fairly stated financial statements.

4. A. Incorrect. The AICPA has ruled that this practice does not violate the Code.
   B. Incorrect. The Code does not prohibit this arrangement. However, according to Conduct Rule 505, such a firm could not designate itself as “Members of the AICPA” unless all CPA-owners are AICPA members.
   C. **Correct.** The AICPA has ruled that audit fees that are long past due take on the characteristics of a loan under Conduct Rule 101. An Ethics Ruling considers independence to be impaired if billed or unbilled fees for client services rendered more than 1 year prior to the report date remain unpaid when the current year’s report is issued. This amount is viewed as a loan to the client and thus impairs independence (certain loans from financial institution clients do not). Thus, independence is impaired and an opinion cannot be expressed if fees for all prior years (year 1) are not collected before issuance of the current (year 2) report. However, long overdue fees would not preclude the CPA from performing services not requiring independence. The Ruling does not apply if the client is in bankruptcy.
   D. Incorrect. No Code provision prohibits the purchase of a bookkeeping firm for a percentage of fees over a given period.

5. A. **Correct.** Conduct Rule 201 requires auditors to exercise due professional care. Moreover, GAAS require that due professional care be exercised in the planning and performance of the audit and preparation of the report. Exercising due professional care requires professional skepticism. Thus, the auditor should have

"an attitude that includes a questioning mind and a critical assessment of audit evidence."

B. Incorrect. Sufficient competent evidence should be examined.

C. Incorrect. The auditor should "plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."

D. Incorrect. The proper balance of professional experience and formal education is required by the first general standard, which states that the audit must be performed by persons with adequate technical training and proficiency.

6. A. **Correct.** An Ethics Ruling states that, prior to disclosing confidential client profit and loss percentages to a trade association, the CPA must have specific client consent.

B. Incorrect. According to an Ethics Ruling, using outside computer services to process tax returns is permissible as long as client confidentiality is maintained.

C. Incorrect. Most CPAs perform consulting services for clients in the same or related industries.

D. Incorrect. According to an Ethics Ruling, CPAs must make full disclosure about any reservations concerning the usefulness of potential consulting services, especially those based on past experience with similar engagements. However, client confidentiality must be preserved or waived.

7. A. Incorrect. Under an Ethics Ruling, after the relationship of a member who is not an owner of the firm is terminated, the member may not take or retain copies or originals from the firm's client files or proprietary information without permission. However, an exception is made when such action is pursuant to a contractual arrangement.

B. Incorrect. An Interpretation of Conduct Rule 501 states that an auditor who retains client records after a demand is made for their return is in violation of the Code even if state law permits the lien.

C. **Correct.** The member's duty to return client records is absolute. However, the duty to return other information not related to the client's books and records is not absolute. Although the client's financial information may be incomplete as a result, if fees for a completed engagement have not been paid, such other information may be withheld. Thus, the duty to return is conditional upon payment of fees with respect to information such as adjusting, closing, combining, or consolidating entries and information normally found in books of original entry and general or subsidiary ledgers.

D. Incorrect. Even though client records are part of the audit working papers, the CPA has an obligation to provide the client with those records.

Glossary

Applied ethics – How moral outcomes can be achieved in specific situations.

Autonomy – Each person should be allowed to make their own decisions based on their lives.

Beneficence – The duty to do good both individually and for all. This principle is mainly associated with the utilitarian ethical theory which we will discuss later in this course.

Confidentiality – The duty to respect privacy of information and action.

Conflict of interest – May occur if a person performs a professional accounting service or professional accounting work for a client or employer and the person has a relationship with another person, entity, product, or service that could, in the person's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the person's objectivity.

Descriptive ethics – The moral values people actually abide by.

Deontology (Kantian ethics) – Deals with the concept of duty and the rightness of acts. It emphasizes maxims, duties, rules, and principles that are so important that they should be followed whatever the consequences.

Ethics (also known as moral philosophy) – A branch of philosophy that addresses questions about morality – that is, concepts such as good and evil, right and wrong, virtue and vice, justice, etc. Ethics can also be defined as "the science of human duty; the body of rules of duty drawn from this science; a particular system of principles and rules concerning duty, whether true or false; rules of practice in respect to a single class of human actions such as political, social, or medical ethics."

Finality – The duty to take action that may override the demands of law, religion, and social customs.

Impair – For purposes of this framework, impair means to effectively extinguish (independence). When a member's independence is impaired, the member is not independent.

Independence in appearance – The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised

Independence of mind – The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

Integrity – An element of character fundamental to professional recognition. It is the quality from which the public trust derives and the benchmark against which a member must ultimately test all decisions.

Justice – All people should be treated fairly.

Least harm – A person should base their decisions on doing the least amount of harm to the fewest number of people.

Meta-ethics – The theoretical meaning and reference of moral propositions and how their truth-values (if any) may be determined.

Moral psychology – How moral capacity or moral agency develops and what its nature is.

Normative ethics – The practical means of determining a moral course of action.

No Harm – Unlike the principle of least harm, this principle requires the duty to cause no harm, both individually and for all.

Objectivity – Imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.

Publicity – The duty to take actions based on ethical standards that must be known and recognized by all who are involved.

Respect for persons – A person should honor others, their rights, and their responsibilities as we honor ourselves. In addition, people should not be used as a means to our end.

Rest's Defining Issues Test (DIT) – Developed by James Rest in 1979, it is designed to assess a person's stage of moral development. The stages used are based on Kohlberg's approach to morality, which places individuals into one of six stages of moral development.

Risk-based approach – Applying the risk-based approach when determining independence generally means that when threats to independence are not at an acceptable level, safeguards must be applied to eliminate the threats or reduce them to an acceptable level.

Safeguards – Controls that mitigate or eliminate threats to independence. Safeguards range from partial to complete prohibitions of the threatening circumstance to procedures that counteract the potential influence of a threat. The nature and extent of the safeguards to be applied depend on many factors, including the size of the firm and whether the client is a public interest entity. To be effective, safeguards should eliminate the threat or reduce to an acceptable level the threat's potential to impair independence.

Threats – Threats to independence are circumstances that could impair independence. Whether independence is impaired depends on the nature of the threat, whether it would be reasonable to expect that the threat would compromise the member's professional judgment and, if so, the specific safeguards applied to reduce or eliminate the threat, and the effectiveness of those safeguards. Pg. 42

Understanding/Tolerance – A person should appreciate and accept other peoples' viewpoints, if reason dictates doing so is warranted.

Utilitarianism (teleological ethics) – The promotion that the best long-term interest of everyone concerned should be the moral standard: one should take those actions that lead to the greatest balance of good versus bad consequences.

Veracity – A person should always be honest and tell the truth.

Appendix

Dear Mr. Lay,

Has Enron become a risky place to work? For those of us who didn't get rich over the last few years, can we afford to stay?

Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting – most notably the Raptor transactions and the Condor vehicle. We do have valuation issues with our international assets and possibly some of our EES MTM positions.

The spotlight will be on us, the market just can't accept that Skilling is leaving his dream job. I think that the valuation issues can be fixed and reported with other goodwill write-downs to occur in 2002. How do we fix the Raptor and Condor deals? They unwind in 2002 and 2003, we will have to pony up Enron stock and that won't go unnoticed.

To the layman on the street, it will look like we recognized funds flow of $800 mm from merchant asset sales in 1999 by selling to a vehicle (Condor) that we capitalized with a promise of Enron stock in later years. Is that really funds flow or is it cash from equity issuance?

We have recognized over $550 million of fair value gains on stocks via our swaps with Raptor, much of that stock has declined significantly – Avici by 98%, from $178 mm to $5 mm. The New Power Co by 70%, from $20/share to $6/share. The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.

I am incredibly nervous that we will implode in a wave of accounting scandals. My 8 years of Enron work history will be worth nothing on my resume, the business world will consider the past successes as nothing but an elaborate accounting hoax. Skilling is resigning now for 'personal reasons' but I think he wasn't having fun, looked down the road and knew this stuff was unfixable and would rather abandon ship now than resign in shame in 2 years.

Is there a way our accounting guru's can unwind these deals now? I have thought and thought about how to do this, but I keep bumping into one big problem – we booked the Condor and Raptor deals in 1999 and 2000, we enjoyed a wonderfully high stock price, many executives sold stock, we then try and reverse or fix the deals in 2001 and it's a bit like robbing the bank in one year and trying to pay back it back 2 years later. Nice try, but investors were hurt, they bought at $70 and $80/share looking for $120/share and now they're at $38 or worse. We are under too much scrutiny and there are probably one or two disgruntled 'redeployed' employees who know enough about the 'funny' accounting to get us in trouble.

What do we do? I know this question cannot be addressed in the all employee meeting, but can you give some assurances that you and Causey will sit down and take a good hard objective look at what is going to happen to Condor and Raptor in 2002 and 2003?

Summary of alleged issues:

Raptor

Entity was capitalized with LJM equity. That equity is at risk; however, the investment was :ompletely offset by a cash fee paid to LJM. If the Raptor entities go bankrupt LJM is not affected, there is no commitment to contribute more equity.

The majority of the capitalization of the Raptor entities is some form of Enron N/P, restricted stock and stock rights.

Enron entered into several equity derivative transactions with the Raptor entities locking in our values for various equity investments we hold.

As disclosed, in 2000, we recognized $500 million of revenue from the equity derivatives offset by market value changes in the underlying securities.

This year, with the value of our stock declining, the underlying capitalization of the Raptor entitie s declining and Credit is pushing for reserves against our MTM positions.

To avoid such a write-down or reserve in Q1 2001, we 'enhanced' the capital structure of the Raptor vehicles, committing more ENE shares.

My understanding of the Q3 problem is that we must 'enhance' the vehicles by $250 million.

realize that we have had a lot of smart people looking at this and a lot of accountants including AA&Co. have blessed the accounting treatment. None of that will protect Enron if these ransactions are ever disclosed in the bright light of day. (Please review the late 90's problems of Waste Management – where AA paid $130+ mm in litigation re: questionable accounting practices).

The overriding basic principle of accounting is that if you explain the 'accounting treatmen o a man on the street, would you influence his investing decisions? Would he sell or buy th tock based on a thorough understanding of the facts? If so, you best present it correctly and/or change the accounting.

My concern is that the footnotes don't adequately explain the transactions. If adequately explained, the investor would know that the "Entities" described in our related party footnote are thinly capitalized, the equity holders have no skin in the game, and all the value in the entities comes from the underlying value of the derivatives (unfortunately in this case, a big loss) AND Enron stock and N/P. Looking at the stock we swapped, I also don't believe any other company would have entered into the equity derivative transactions with us at the same prices or without substantial premiums from Enron. In other words, the $500 million in revenue in 2000 would have been much lower. How much lower?

Raptor looks to be a big bet, if the underlying stocks did well, then no one would be the wiser. If Enron stock did well, the stock issuance to these entities would decline and the transactions would be less noticeable. All has gone against us. The stocks, most notably Hanover, The New Power Co., and Avici are underwater to great or lesser degrees.

I firmly believe that executive management of the company must have a clear and precise knowledge of these transactions and they must have the transactions reviewed by objective experts in the fields of securities law and accounting. I believe Ken Lay deserves the right to judge for himself what he believes the probabilities of discovery to be and the estimated damages to the company from those discoveries and decide one of two courses of action:

1. The probability of discovery is low enough and the estimated damage too great; therefore we find a way to quietly and quickly reverse, unwind, write down these positions/transactions.
2. The probability of discovery is too great, the estimated damage to the company too great; therefore, we must quantify, develop damage containment plans and disclose.

I firmly believe that the probability of discovery significantly increased with Skilling's shocking departure. Too many people are looking for a smoking gun.

Appendix

Summary of Raptor oddities:

1. The accounting treatment looks questionable.

   a. Enron booked a $500 mm gain from equity derivatives from a related party.
   b. That related party is thinly capitalized, with no party at risk except Enron.
   c. It appears Enron has supported an income statement gain by a contribution of its own shares.

   One basic question: The related party entity has lost $500 mm in its equity derivative transactions with Enron. Who bears that loss? I can't find an equity or debt holder that bears that loss. Find out who will lose this money. Who will pay for this loss at the related party entity?

   If it's Enron, from our shares, then I think we do not have a fact pattern that would look good to the SEC or investors.

2. The equity derivative transactions do not appear to be at arms length.

   a. Enron hedged New Power, Hanover, and Avici with the related party at what now appears to be the peak of the market. New Power and Avici have fallen away significantly since. The related party was unable to lay off this risk. This fact pattern is once again very negative for Enron.
   b. I don't think any other unrelated company would have entered into these transactions at these prices. What else is going on here? What was the compensation to the related party to induce it to enter into such transactions?

3. There is a veil of secrecy around LJM and Raptor. Employees question our accounting propriety consistently and constantly. This alone is cause for concern.

   a. Jeff McMahon was highly vexed over the inherent conflicts of LJM. He complained mightily to Jeff Skilling and laid out 5 steps he thought should be taken if he was to remain as Treasurer. 3 days later, Skilling offered him the CEO spot at Enron Industrial Markets and never addressed the 5 steps with him.
   b. Cliff Baxter complained mightily to Skilling and all who would listen about the inappropriateness of our transactions with LJM.
   c. I have heard one manager level employee from the principle investments group say "I know it would be devastating to all of us, but I wish we would get caught. We're such a crooked company." The principle investments group hedged a large number of their investments with Raptor. These people know and see a lot. Many similar comments are made when you ask about these deals. Employees quote our CFO as saying that he has a handshake deal with Skilling that LJM will never lose money.

4. Can the General Counsel of Enron audit the deal trail and the money trail between Enron and LJM/Raptor and its principals? Can he look at LJM? At Raptor? If the CFO says no, isn't that a problem?

Condor and Raptor work:

1. Postpone decision on filling office of the chair, if the current decision includes CFO and/or CAO.

2. Involve Jim Derrick and Rex Rogers to hire a law firm to investigate the Condor and Raptor transactions to give Enron attorney client privilege on the work product. (Can't use V&E due to conflict – they provided some true sale opinions on some of the deals).

3. Law firm to hire one of the big 6, but not Arthur Andersen or PricewaterhouseCoopers due to their conflicts of interest: AA&Co (Enron); PWC (LJM).

4. Investigate the transactions, our accounting treatment and our future commitments to these vehicles in the form of stock, N/P, etc..
   For instance: In Q3 we have a $250 mm problem with Raptor 3 (NPW) if we don't 'enhance' the capital structure of Raptor 3 to commit more ENE shares.
   By the way: in Q1 we enhanced the Raptor 3 deal, committing more ENE shares to avoid a write down.

5. Develop clean up plan:

   a. Best case: Clean up quietly if possible.

   b. Worst case: Quantify, develop PR and IR campaigns, customer assurance plans (don't want to go the way of Salomon's trading shop), legal actions, severance actions, disclosure.

6. Personnel to quiz confidentially to determine if I'm all wet:
   a. Jeff McMahon
   b. Mark Koenig
   c. Rick Buy
   d. Greg Whalley

Appendix

To put the accounting treatment in perspective I offer the following:

1. We've contributed contingent Enron equity to the Raptor entities. Since it's contingent, we have the consideration given and received at zero. We do, as Causey points out, include the shares in our fully diluted computations of shares outstanding if the current economics of the deal imply that Enron will have to issue the shares in the future. This impacts 2002 – 2004 EPS projections only.

2. We lost value in several equity investments in 2000. $500 million of lost value. These were fair value investments, we wrote them down. However, we also booked gains from our price risk management transactions with Raptor, recording a corresponding PRM account receivable from the Raptor entities. That's a $500 million related party transaction – it's 20% of 2000 IBIT, 51% of NI pre tax, 33% of NI after tax.

3. Credit reviews the underlying capitalization of Raptor, reviews the contingent shares and determines whether the Raptor entities will have enough capital to pay Enron its $500 million when the equity derivatives expire.

4. The Raptor entities are technically bankrupt; the value of the contingent Enron shares equals or is just below the PRM account payable that Raptor owes Enron. Raptor's inception to date income statement is a $500 million loss.

5. Where are the equity and debt investors that lost out? LJM is whole on a cash on cash basis. Where did the $500 million in value come from? It came from Enron shares. Why haven't we booked the transaction as $500 million in a promise of shares to the Raptor entity and $500 million of value in our "Economic Interests" in these entities? Then we would have a write down of our value in the Raptor entities. We have not booked the latter, because we do not have to yet. Technically, we can wait and face the music in 2002 – 2004.

6. The related party footnote tries to explain these transactions. Don't you think that several interested companies, be they stock analysts, journalists, hedge fund managers, etc., are busy trying to discover the reason Skilling left? Don't you think their smartest people are pouring over that footnote disclosure right now? I can just hear the discussions – "It looks like they booked a $500 million gain from this related party company and I think, from all the undecipherable ½ page on Enron's contingent contributions to this related party entity, I think the related party entity is capitalized with Enron stock." ….. "No, no, no, you must have it all wrong, it can't be that, that's just too bad, too fraudulent, surely AA&Co wouldn't let them get away with that?" ….. "Go back to the drawing board, it's got to be something else. But find it!" …… "Hey, just in case you might be right, try and find some insiders or 'redeployed' former employees to validate your theory."