

Avoiding Jail Time and Other Annoying Career Interruptions – Some Ethical Considerations for CPAs

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ETHICS AND THE ART OF ACCOUNTING



What is “Ethics”?

Webster’s definitions:

- Ethics “the principles of conduct governing an individual or a group <professional *ethics*>”
- Profession: “a calling requiring specialized knowledge and often long and intensive academic preparation”
- Are CPAs in industry members of a “profession”?



AICPA – Guidance Professional Conduct

Principles

- Responsibilities
- Public Interest
- Integrity
- Objectivity and Independence
- Due Care
- Scope and Nature of Services

AICPA – Guidance for CPAs in Industry

- Duty to external accountants
 - Candid
 - Full disclosure
- Subordination of judgment
 - Failure to record transactions
 - Misleading financial statements
- Ultimate solution to conflict: resign from the company!

AICPA Guidance – Subordination of Judgment

Interpretation 102-4 (Subordination of Judgment by a Member) During the performance of a professional service (all services performed by a member while holding out as a CPA), a member should not subordinate his or her judgment to the position taken by a supervisor. Specifically, if there is a disagreement about the preparation of financial statements or the recording of a transaction, the member should observe the following guidelines.

- Determine whether the position taken by the supervisor is consistent with an acceptable alternative accounting principle. If the principle is generally acceptable, the member does not need to take additional action.
- If the member determines that the alternative accounting principle is not acceptable, the member should communicate the disagreement to an “appropriate higher level(s) of management with the organization.” This higher level could include the supervisor’s supervisor, members of senior management or the audit committee
- If, after the appropriate higher level(s) of management was informed of the disagreement, appropriate action was not taken, the member should consider whether to continue as an employee and whether there is any responsibility to notify appropriate regulatory agencies or the employer’s current or former external accountant. Consultation with legal counsel may be appropriate before communicating with external parties.

Ethics Quiz

A member is hired by a company as the chief financial officer. The member later discovers that, prior to his or her employment, material false and misleading entries were recorded in the books and records of the company. If he or she fails to record a correcting entry, is the member in violation of the AICPA Code of Professional Conduct?



Source: Professional Ethics Division

Ethics Quiz

(cont'd)

A member is the controller of a company. The company's external auditors request, and the member provides them with, copies of documents relating to the company's revenue-recognition policy. However, the member does not disclose the existence of other documents that would reveal the company is improperly and prematurely recording revenue which has a material impact on the company's financial statements. Is the member in violation of the AICPA code?

Source: Professional Ethics Division

Ethics Quiz

(cont'd)

A supervisor instructs a member to record a transaction that would result in a material misstatement of the financial statements. If, after appropriate research and consultation, the member determines that the transaction cannot be recorded using an acceptable alternative, should he or she comply with the supervisor's instructions?

Source: Professional Ethics Division

IMA Ethics Guidance



Ethics Statement issued in November 2005 with four features:

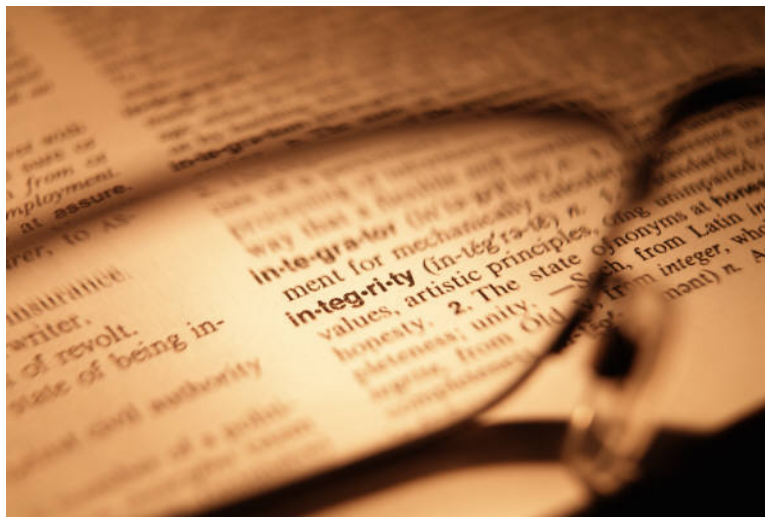
- Introductory paragraph
- Principles
- Standards
- Resolution of Ethical Conflict

IMA Ethics Guidance

(cont'd)

Standards – subject to disciplinary action – include four areas:

- Competence
- Confidentiality
- Integrity
- Credibility



IMA Ethics Guidance

(cont'd)

The Principles include:

- Honesty
- Fairness
- Objectivity
- Responsibility

IMA Ethics Guidance

(cont'd)

Process to Resolve Conflicts:

- Report up the ladder – all the way to Board, if necessary
- But not to someone who may be involved in any misconduct
- Consult an IMA ethics counselor
- Consult attorney

IMA Guidance

- **Confidentiality:** Each IMA member has a responsibility to: keep information confidential except when disclosure is authorized or legally mandated.
- **Integrity:** Each IMA member has a responsibility to: mitigate actual conflicts of interest. Regularly communicate with business associates to avoid apparent conflicts of interest. Advise all parties of any potential conflicts.
- **Credibility** (formerly Objectivity): Each IMA member has a responsibility to disclose all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, analyses, or recommendations.

IFAC Code of Ethics

- International Federation of Accountants (IFAC)
- Revised Code of Ethics for Professional Accountants
- Effective January 1, 2011
- Separate section for “Professional Accountants in Business”



IFAC Code of Ethics

(cont'd)

Fundamental Principles

- Integrity
- Objectivity
- Professional Competence and Due Care
- Confidentiality
- Professional Behavior

IFAC Code of Ethics

(cont'd)

Threats to Principles

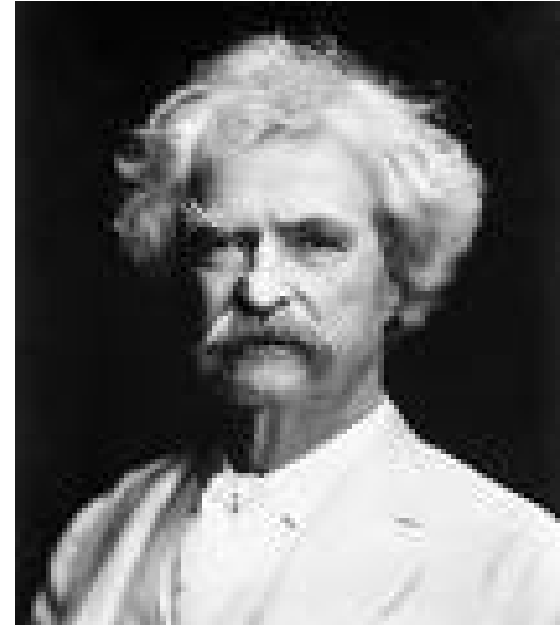
- Self-interest
- Self-review
- Advocacy
- Familiarity
- Intimidation

Examples of Threats to Ethical Principles

- You (CPA) recommended a particular accounting method that later turns out to be incorrect
- Your friend or family member is a vendor
- No one is reviewing your work papers and there's an error in your spreadsheet
- Incentive compensation plans motivate you to increase EPS
- Domineering boss persecutes you when you disagree on technical matters

Mark Twain on Ethics

“Always do right. This will gratify some people and astonish the rest.”



Nightmare Scenario – Assistant Controller

- First Quarter – you discover potential revenue recognition problem; consult with Controller; it appears immaterial; decide to investigate further
- Second Quarter – there is definitely a problem; more material than was thought; Controller says let's not tell the CFO, he will only get upset – let's fix it next quarter

Nightmare Scenario – Assistant Controller

(cont'd)

- Third Quarter – to correct the problem would wipe out half of quarter's EPS; CFO says we have to make our numbers; we will spread the write-off over next four quarters; don't tell the auditors
- Fourth Quarter – receive a call from Investor Relations; rumor that there is a problem with revenue; what should we tell the shareholders?

“Looking for Earnings in All the Wrong Places”

Our numbers look a little low this quarter – is it ok to adjust:

- Loan loss reserves
- Expense accruals
- Inventory valuation accounts



Other Common Corporate Ethics Issues

- Padding expense accounts
- Hiding negative information
- Deliberately ignoring company policies
- Misrepresentations to customers, vendors, creditors
- Misleading statements about your qualifications
- Accepting gifts from suppliers
- Manipulating department reports or budgets
- Improper payments to customers, suppliers
- Personal use or misuse of company resources (including information and technology)

LRN Ethics Study

- 834 full-time employees from various industries
- 80% had disagreement with the ethics of supervisor, fellow employee or management
- 21% felt pressure to engage in illegal activity
- 25% witnessed illegal or unethical activity in the last 6 months

Source: Strategic Finance – November 2006

2007 National Business Ethics Survey

- 2000 employees at US private and public companies
- 56% personally observed violations of company ethics standards, policy or law
- 42% who witnessed misconduct did not report it; of those:
 - 54% did not expect company would take corrective action
 - 36% feared retaliation

Source: Strategic Finance January 2008

Common Rationalizations

- Everybody else does it
- They'll never miss it
- Nobody will care
- The boss does it
- No one will know
- I don't have time to do it right
- That's close enough
- Some rules meant to be broken
- It's not my job

Source: Strategic Finance – November 2006

Attorneys at Law | www.agg.com



What do These People Have in Common?

Steven J. Landmann

Sharlene Abrams

Gary C. Gerhardt

Michael Byrd

David Kreinberg

Antonio Canova

Michael Pattison

Francis Jewels

Carole Argo

Carl Jasper

What do These People Have in Common?

(cont'd)

Paul Venesky

Joseph Rougraff

Michael Resnick

William DeLoach

Lisa Zappala

Suzanne Brown

Weston Smith

Randy Casstevens

Judith Kudla

William Shovers

Alvin Dahl

Kevin Morano

What do These People Have in Common?

- Eric Sieracki
- David E. Watson
- Danielle Valkner
- James M. Schneider
- Paul R. Beckwith
- Leslie L. Jackson
- Randall M. Imhoff
- Patti M. Dodge
- Kevin J. Schott
- Stephen Burke
- Mark T. Schwetschenan
- Kenneth J. Abod
- Ilse Cappel
- Anthony Bonica
- Sandra Miller
- Deanna J. Serugn
- Carl W. Jasper
- Eric A. Holzer
- Eric J. Bur
- Milan Belans
- Catherine Rozanski
- Robert W. Davis
- Stephen Durland
- David N. Kenneally
- Stephen D. Chamsler
- Larry Lee Crawford
- Larry E. Hulse
- Andrew D. Petrosky
- Harry O. Nicodemus IV
- Kevin Krakora
- Mark Bloom
- John W. Dwyer

What do These People Have in Common?

(cont'd)

Don Cole

Theodore Fricke

Robert Putnam

Eric Tyra

Elaine Decker

William Wiseman

David Decker

“Tone at the Top”

What if the Corporate Code says “Do the Right Thing” but the Corporate Culture says “Do Whatever it takes to Close the Deal”?



Ethics Resources

- AICPA Antifraud & Corporate Responsibility Center
http://www.aicpa.org/InterestAreas/YoungCPANetwork/Resources/ProfessionalIssues/Pages/Fraud_Initiative.aspx
- IMA Ethics helpline – 1.800.245.1383
- IMA Ethics Center
http://www.imanet.org/resources_and_publications/ethics_center_helpine.aspx
- Ethics Resource Center www.ethics.org
- Business Ethics Magazine www.business-ethics.com
- International Federation of Accountants www.ifac.org



SOME MEASURES TO PREVENT FRAUD



Types of Management Behavior Underlying Financial Restatements

- Normal human error
- Understaffing/under-resourcing
- Willful blindness
- “Aggressive” favorable accounting treatment
 - Somewhat justified?
 - Totally bogus?
- Aggressive sales pitch to auditors
- Culpable fraud
- Culpable fraud plus deliberate cover-up

Establishing the Right Tone for Ethical Culture

- Talk about the importance of ethics
- Model ethical conduct
- Keep promises and commitments
- Keep employees informed
- Hold employees accountable

Source: P. Harned, Compliance Week, 9/6/06

Creating a Culture to Prevent Financial Fraud

- Fraudulent financial reporting by upper-level management typically involves override of internal controls within the financial reporting process. Because management has the ability to override controls, or to influence others to perpetrate or conceal fraud, the need for a strong value system and a culture of ethical financial reporting becomes increasingly important. This helps create an environment in which other employees will decline to participate in committing a fraud and will use established communication procedures to report any requests to commit wrongdoing. The potential for management override also increases the need for appropriate oversight measures by the board of directors or audit committee . . .



Creating a Culture to Prevent Financial Fraud

(cont'd)

- Fraudulent financial reporting by lower levels of management and employees may be deterred or detected by appropriate monitoring controls, such as having higher-level managers review and evaluate the financial results reported by individual operating units or subsidiaries. Unusual fluctuations in results of particular reporting units, or the lack of expected fluctuations, may indicate potential manipulation by departmental or operating unit managers or staff.

Source: Statement on Auditing Standards No. 99, Considerations of Fraud in a Financial Statement Audit by American Institute of Certified Public Accountants, Inc.



Suggested Measures to Prevent Financial Statement Fraud

- Adopt a culture of high ethical values
- Adopt a culture of accountability
- Talk about the possibility of fraud
- Give permission to blow the whistle
- Analytic review of financial statements
 - Why did the ratio not change
 - Healthy skepticism
- Emphasize sustainable growth over short-term gains

SEC Enforcement



Mary Schapiro

Heavy SEC Caseload

Number of settled enforcement actions, by year:

	<u>All Types</u>	<u>Misstatements</u>
2006	678	102
2007	717	170
2008	673	131
2009	626	121

From 2002 to 2008, the SEC settled with a total of 197 companies and 700 individuals on charges related to misstatement cases.

Source: Nera Economic Consulting, SEC Settlements Trends Report (12/9/09)

SEC Aggressively Pursues Enforcement Against Accountants

- CPA Firms
- Individual CPAs in public accounting
- CPAs in industry
 - CFOs
 - Controllers
 - Lower-level accountants
 - Other financial executives
- Also – Audit Committee members



Are You “Practicing Before the Commission”?

Some accountants who may be:

- CFOs, controllers, other financial professionals
- Internal and external auditors
- Consultants who provide data for SEC reports or assist auditors

If so, subject to regulation by the SEC under Rule 102(e)

Recent SEC Case – James Schneider, CPA (7/10) CFO of Dell, Inc.

- Allegations include:
 - Improper accounting
 - Disclosure violations
 - Misrepresentation to auditors
- Suspended from practicing before the SEC, and \$3.1 million in penalties

Will You Be Prosecuted?

Antonia Chion, Associate Director, identified factors that the Division of Enforcement will consider in evaluating option backdating cases:

- How egregious was the conduct?
- What is the quality of the evidence?
 - e.g., is there evidence of alteration or falsification?
- The duration of the conduct (number of instances of backdating)?
- What is the quantitative materiality of unrecorded compensation expense?
- Is there a restatement and, if so, how large?



Will You Be Prosecuted?

(cont'd)

- Scien^{ter} – What is the knowledge of the individuals?
- Is there evidence of concealment, obstruction or lying?
- Does anyone have money in pocket?
- Did other non-options misconduct occur?
- What about cooperation and remedial acts?

A Really Bad Idea

Language accompanying option grant agreement:

“Our goal is to ensure the best possible out-come for the employees receiving options in this grant. For this reason we will be delaying the communication of the annual grant information for a little longer. I will let you know as soon as we have the grant date and strike price. At that time we will email your approval spreadsheets so you and your management team can let the employees know the detail of their grants.”

PCAOB Enforcement

- Regulates registered firms and their individual CPAs
- May open an investigation and bring sanctions
- May refer matters to state board of accountancy or SEC



Sanctions for Violations

- Penalties
 - ✓ Up to \$15 million for firm
 - ✓ Up to \$750,000 for individual
- Temporary or permanent suspension of registration
- Person's disassociation from firm
- Limitations on firm's activities
- Require an independent monitor to observe and report
- Censure
- Additional education

PCAOB Hotline

- Contact PCAOB 800.741.3158
- Report violations online
www.pcaobus.org/enforcement/tips/index.aspx



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