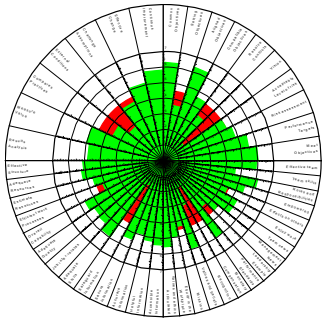


Immunity

Creating and Sustaining an Ethical Business Environment



Paul Makosz

CEO PDK Control Consulting International

Chairman IIA International Ethics Committee

www.csa-pdk.com



agenda

- Recent breakdowns - a systemic virus?
- Ethics
- Your role as CAE
- Understanding people
- Immunizing your organization



Memorable thoughts

- *We won the [cold] war.* - Reagan
- *It's the economy, stupid.* - Clinton
- *9/11..an attack on our values..* - Bush
- *We've done nothing wrong.* - AICPA
- *God gave us this land.* - Rabbi
- *When you are big, be the good guy.* - Chrétien



Memorable headlines

Executive Privilege

How Tyco's CEO Enriched Himself

CEOs' Wealth
May Be at Stake
In Investor Suits

Some Directors
Of Tyco Expected
To Step Down

*Documents Suggest
WorldCom Leaders
Knew of Violations*

By YOCHI J. DREAZEN
And DEBORAH SOLOMON

WASHINGTON—WorldCom Inc.'s controller acknowledged to internal auditors in mid-June that the way the company was trying to disguise expenses violated accounting standards, but warned worsening financial conditions left it no other choice, according to documents released yesterday by congressional investigators.

Mr. Kozlowski, Ex-Chief,
Got Secret Loans, Spent
Firm's Cash as His Own

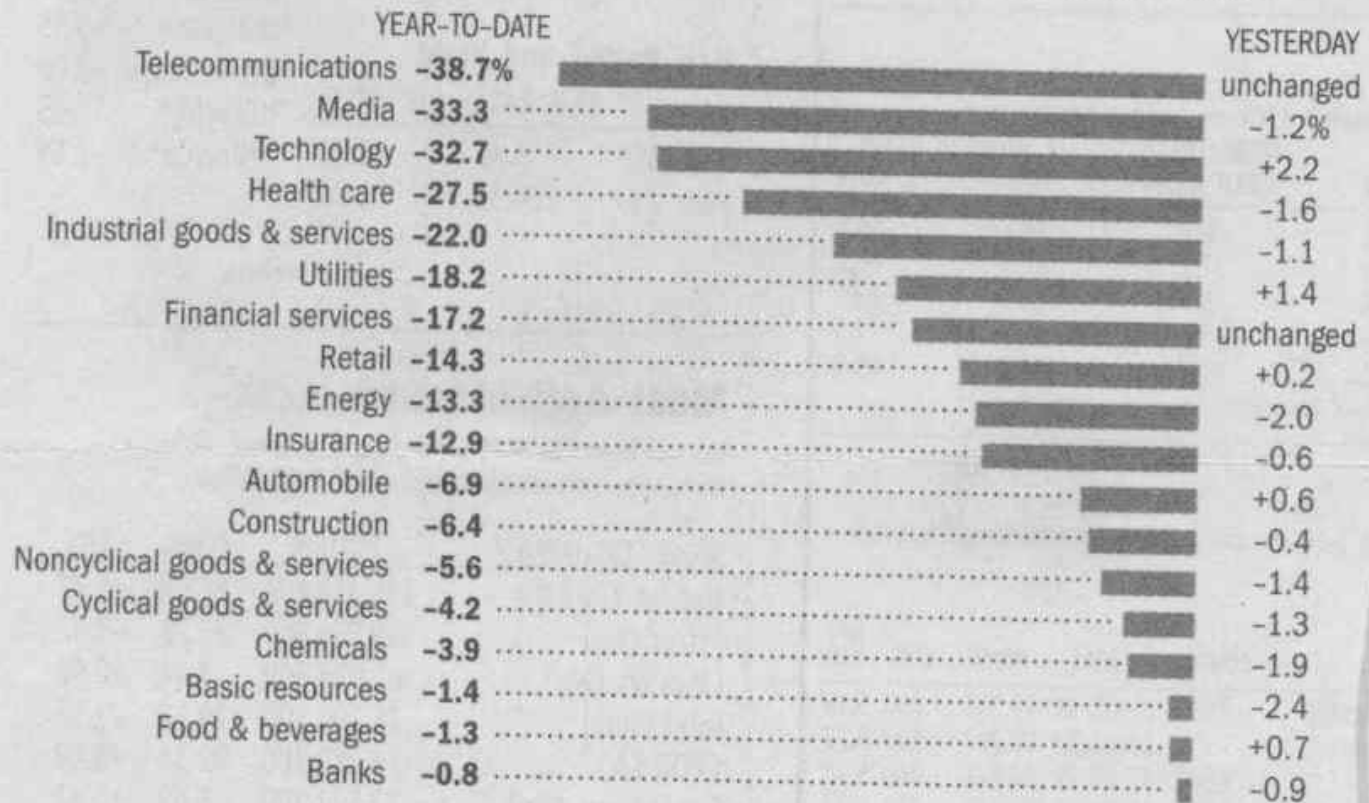
A \$6,000 Shower Curtain

*Tax Probe of Adelphia Founders
Follows Filing of Fraud Charges*

Impact on markets

Still, this year's decline has struck all sectors

Performance of the 18 market sectors of the Dow Jones U.S. Total Market Index, whose components represent 95% of the total capitalization of the market





Impact on new investment

In 1999, the median age of companies
in new stock offerings was 4 years.
Now it's 15.

NYT, May 19 2002



Impact on Ordinary Investors

Left in the Lurch

For Investors Near Retirement,
Stock Fall Poses Stark Choices

Some May Hang On to Jobs,
Shun Risk or Try to Take
Cash out of Their Homes

Implications for the Economy

“I’ve worked two jobs for the last 12 years and put the maximum into my 401K. Now I’ve lost almost half of it in 7 months.”

Taxi-driver in Washington DC



A generous offer

- Gary Winnick, [ex-chairman of Global Crossing] told a Congressional committee today that he would write a check for \$25 million to cover part of the retirement money several thousand employees lost
- Winnick made \$734 million from the stock before the shares became worthless

New York Times
October 2 2002

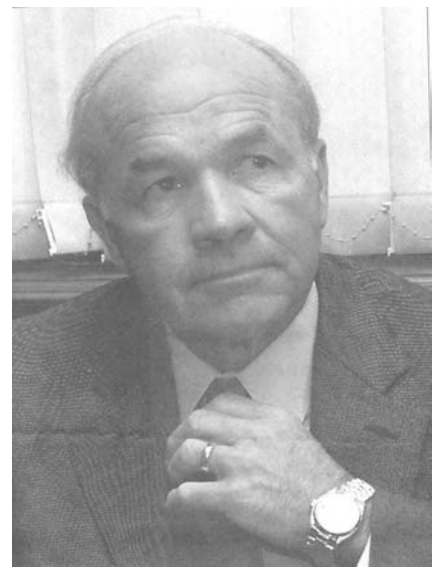
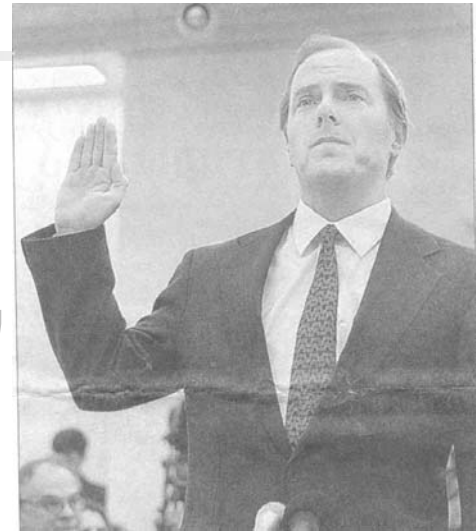


Enron, Andersen: root causes and conspiracies

Management



**"Not an
Accountant"**



Root causes - leadership and the control environment

- 1 **Ethics**
- 2 **Ambition**
- 3 **Complexity**

Enron
workers
lived on
the edge

Corporate Veil

Behind Enron's Fall,
A Culture of Operating
Outside Public's View

Hidden Deals With Officers
And Minimal Disclosure
Finally Cost It Its Trust

Chewco and JEDI Warriors

Enron Official Tells of 'Arrogant' Culture

WSJ - Feb 15/02

*En-Ruse? Workers Say They Had to Pose
As Busy Traders to Impress Visiting Analysts*



The ethics of Special Purpose Entities (SPEs)

- Partnership or other vehicle designed to offload Enron debt and increase revenue
- Sell non-performing assets to the SPE at high value: reduce debt, increase cash flow
- Guarantee the SPE using Enron stock

“All they were doing was looking at GAAP and FASB documents and saying, “Well this is what it says,” and then finding the most byzantine way to get around the law so that it’s still legal but violating the spirit.”

Financial Times, quoting former Enron employee



The ethics of electricity

Get Shorty and Fat Boy

- WASHINGTON, May 15 — Enron lawyers alerted senior company executives in October 2000 to trading strategies that Enron was using in the California electricity market, and concluded in December 2000 that the tactics were "potentially criminal." Only then did the company order the maneuvers stopped, according to Senate testimony today.

NYT, May 16, 2002

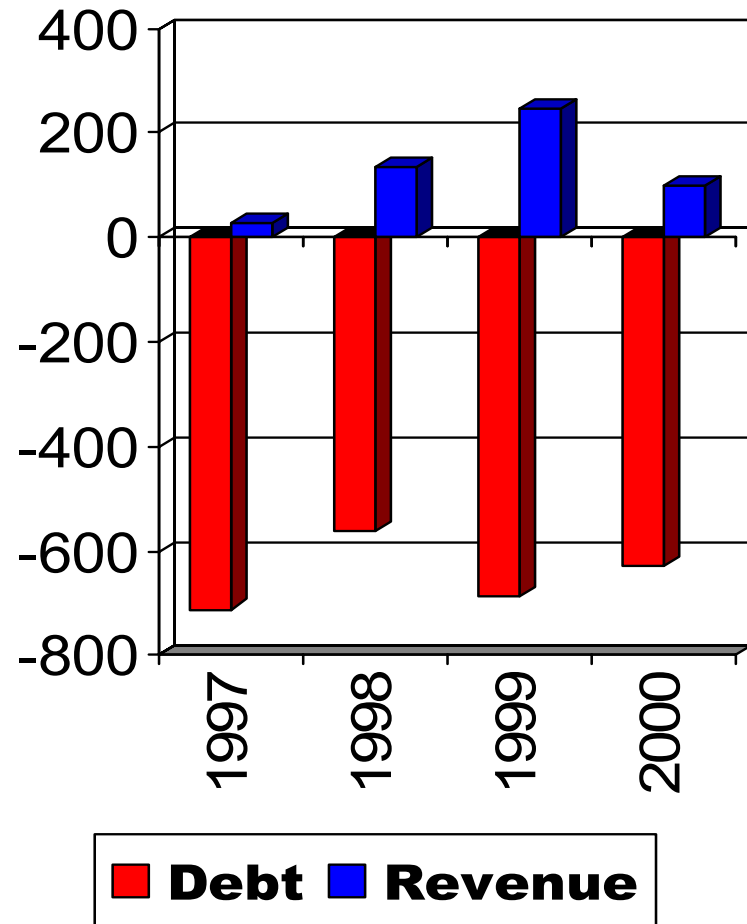
Ambition

We are Number 7 now [in the Fortune 500].
I believe within two years we will be
Number 1.



Complexity - house of cards - Chewco and LJM1

- Debt reductions
- Revenue increases
- From just 2 SPEs
- There were over 3500 SPEs by the end
- SPEs supported by Enron stock guarantees with pre-set “triggers”

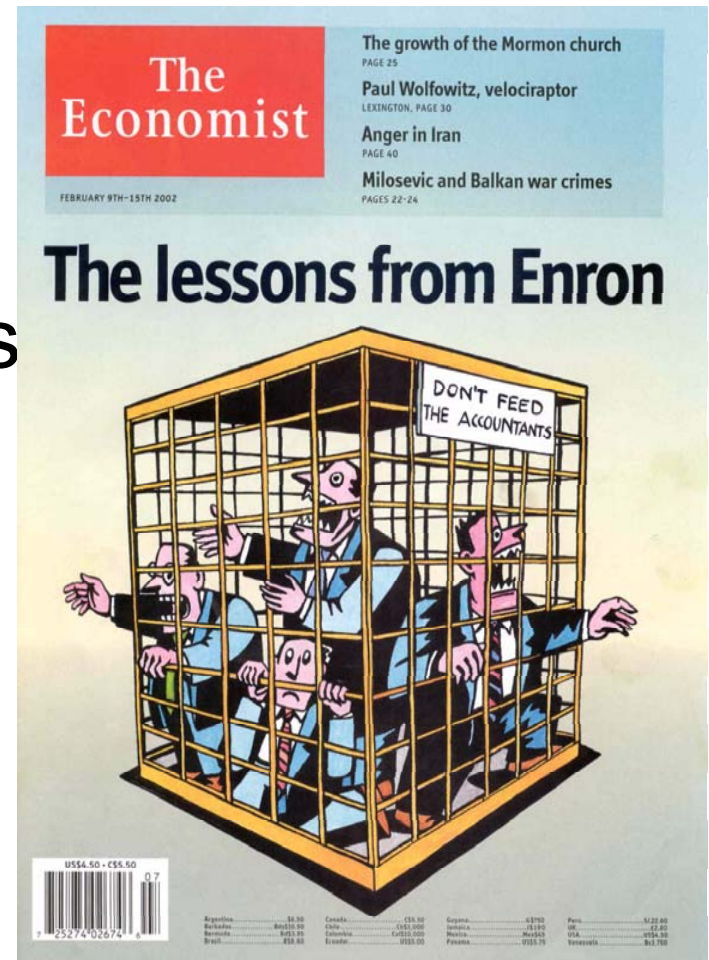




Aided and Abetted by

The Collaborators

- Accountants
- Bankers
- Stockbroker Analysts
- Lawyers
- Government
- Directors
- Other “bright sparks”



Andersen client accounting frauds in the late 1990s

- Colonial Realty
- Sunbeam (\$110M)
- Baptist Foundation of Arizona (\$217 M)
- Waste Management

Globe and Mail - June 20, 2001

SEC hits Arthur Andersen with \$7-million in fines

Accounting firm, partners agree to pay over Waste Management fraud allegations

PDK



After Waste Management fine, AA signs SEC agreement to avoid wrongdoing



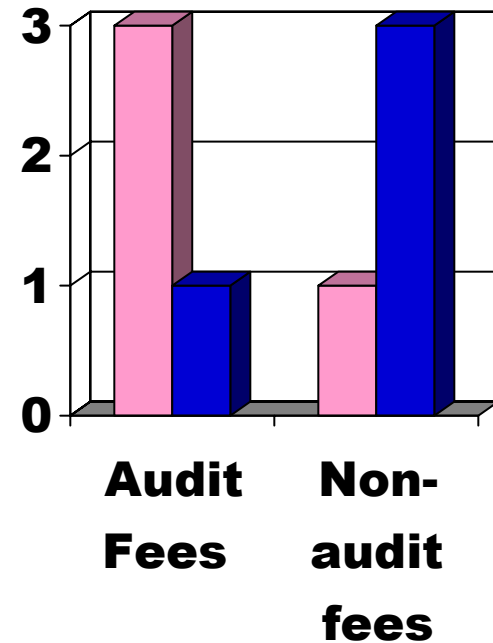
Sweethearts

- After Andersen signed off on ..the 1993 financials...the CEO rewarded Andersen by granting a \$3.7 million consulting contract to ..Andersen Consulting [for] an 11 month “strategic review”
- The review, which one former WM director described as a “boondoggle”, was abandoned after 11 months

Details from SEC suit as quoted by WSJ, March 27, 2002

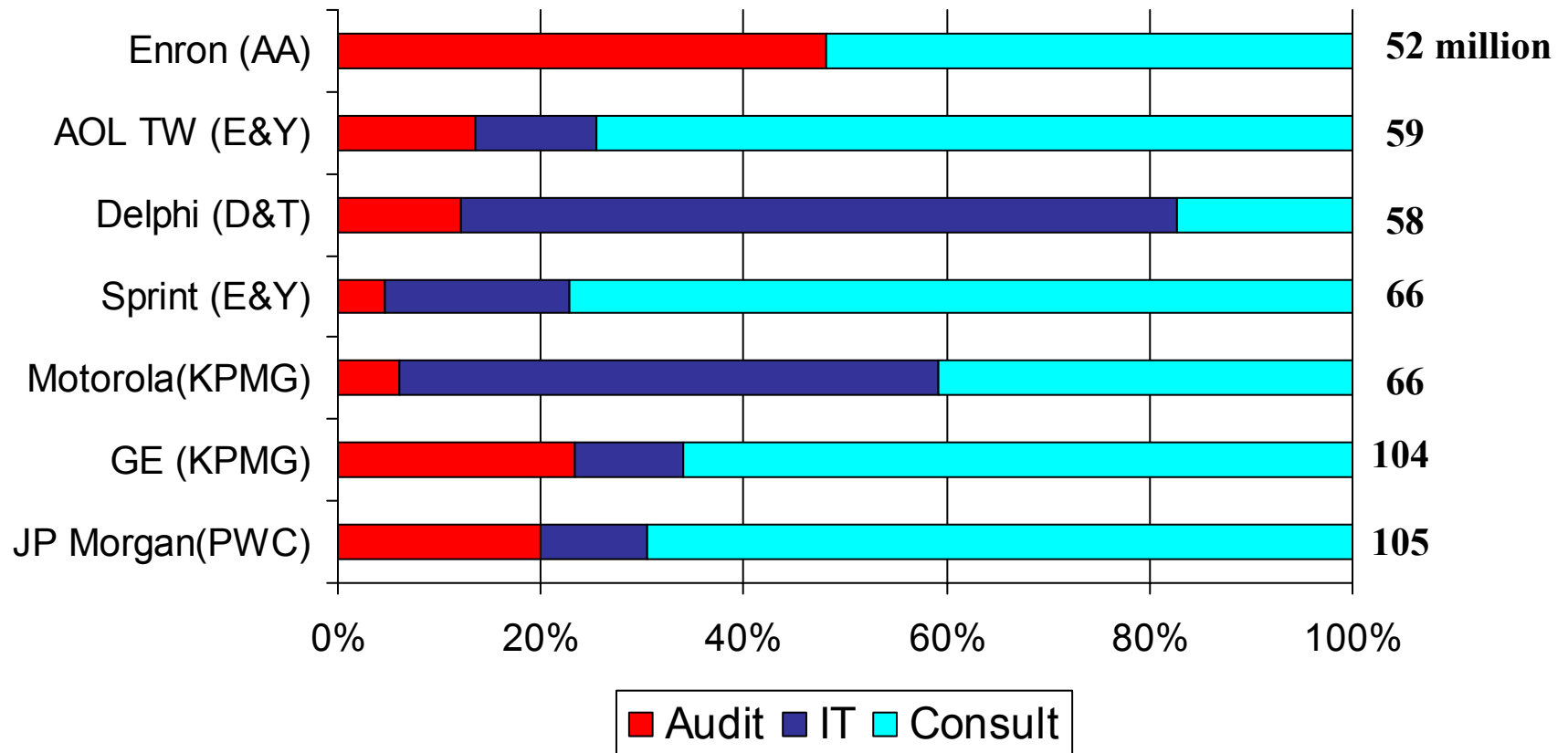
Is this GAAP?

- AICPA in 2000 said audit fees amounted “typically” to 3 x non-audit fees
- Proxy filings in 2001 and 2002 revealed the opposite, and in many cases the factor was much higher



■ AICPA ■ Proxy Filings

Auditor conflict of interest



Banks helpful - to a fault!

Citigroup Deals Helped Enron Raise Loans Disguised as Cash

Unusual Accounting: Citigroup Financing Became Enron Cash

Enron's Enablers

Citigroup and Morgan have some explaining to do.

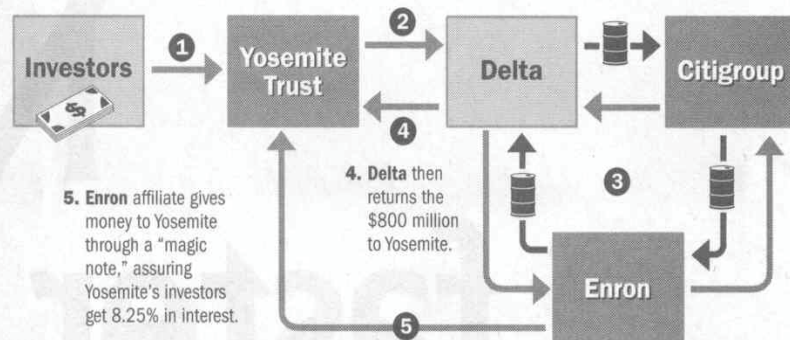
Wall Street Journal

PDK

How Financing Becomes Trades

Documents show Citigroup's complex Yosemite transaction allowed Enron to disguise financing as trades to avoid booking it as debt. Here's how the money flowed:

1. Investors buy roughly \$800 million in bonds issued by Yosemite.
2. Yosemite gives \$800 million to Delta, a Citigroup-controlled, special-purpose entity in the Cayman Islands.
3. Delta starts circular transaction, which gives \$800 million first to Enron, then to Citigroup, then back to Delta. Oil is then scheduled to flow in the opposite direction, from Enron to Delta to Citigroup then back to Enron. The transactions effectively cancel each other out.



Sources: Enron documents; U.S. Senate Permanent Subcommittee on Special Investigations



Spreading the virus

Congress Probes Merrill-Enron Deal

Investigators in Congress believe a 1999 deal with Enron was a sham designed to help the firm hide debt.

Citigroup, J.P. Morgan Marketed Enron-Type Deals to Other Firms

Wall Street Journal



Why little investors have fled

- ML tells the public “BUY” but internal memos call stock “junk” or “crap”
- Big companies give analysts information three days before public announcements
- Banks give Ebbers et al. big IPO rewards
- none for the little guy
- Investor no longer sees auditors as trustworthy

Recent examples

WSJ January, February 2003

IPO 'Laddering' Case Expands

Big Pops
Here are five IPOs being scrutinized by the SEC staff as part of its 'laddering' probe

IPO DATE	COMPANY	FIRST-DAY PRICE GAIN	UNDERWRITER
Feb. 3, 2000	Avanex	378%	Morgan Stanley
June 26, 2000	Marvell Technology Group	278	Goldman Sachs
July 27, 2000	Avici Systems	212	Morgan Stanley
Sept. 25, 2000	CoSine Communications	142	Goldman Sachs
Nov. 6, 2000	Transmeta	115	Morgan Stanley

Sources: Wall Street Journal research, Thomson Financial

Ahold Case May Damp Exemption For Foreign Accountants by SEC

By JONATHAN WEH... on other nations in response to corporate

New SEC Definition May Cloud 'Audit Fees'

By JONATHAN WEH...

A New Entry for the Accounting Dictionary

The SEC is proposing to broaden the definition of audit fees it adopted in November 2000.

How 'audit fees' were defined in November 2000:

The fee paid for the annual audit and for the review of the company's financial statements included in the company's Forms 10-Q or 10-QSB for the most recent fiscal year.

What the SEC now proposes to also allow as part of reported 'audit fees':

"In addition to including fees for services necessary to perform an audit or review in accordance with GAAS, this category also may include services that generally only the independent accountant can reasonably provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of documents filed with the Commission."

Note: GAAS are generally accepted auditing standards.

Troubling Options

Inside the Tough Call at Sprint: Fire Auditor or Top Executives?

KPMG Is Likely to Face Fraud Charge



Qwest insider stock profits

- CEO \$227 million
- CFO \$29 million
- General Counsel \$13 million
- Director \$1.5 billion

(1999 -2001 company profits inflated by round tripping with AOL and WorldCom)

New York Times
July 30 2002

Ex-Executives
Are Indicted
In Qwest Probe



Missing the point

- If we risk being liable, become an LLP
- If our own documents helped convict us, let's have a policy to destroy documents
- If we lose our consulting business, double our efforts to build new consulting clients
- If the SEC chair threatens us, lobby Government
- Hard to detect fraud? Disclaim liability for it.



Is this a systemic virus?

JP Morgan
Merrill Lynch
Enron
Conseco
Tyco
Global Crossing
Credit Suisse FB
Citigroup
Arthur Andersen
Qwest
Adelphia
El Paso
Homestore
AON
Xerox
Dynergy
KPMG
KMart
Salomon
AOL Time Warner
WorldCom
Williams Companies
Ahold

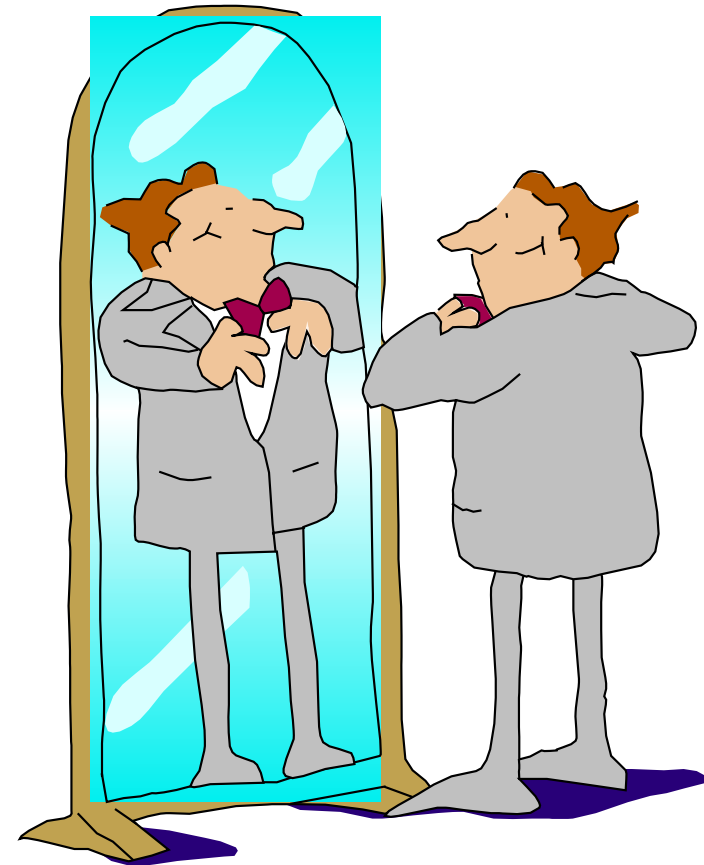


Your role as CAE

Your role

- Everyone else in the game has been tagged and is “out”
- So

You're **IT**



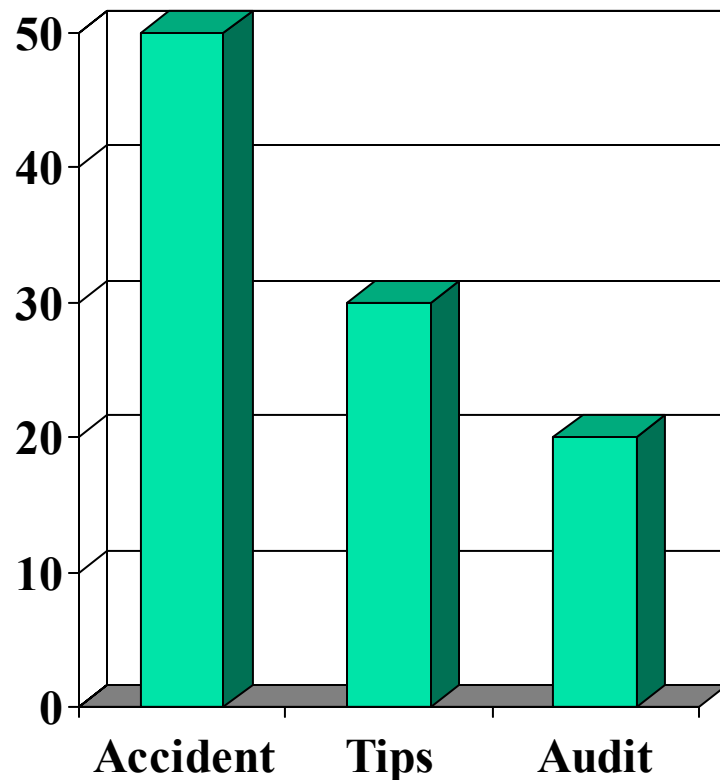


IIA on the Auditor's Role in Ethics

- Governance & Organizational Culture
- Shared Responsibility for the Organization
- Internal Auditing as Ethics Advocate
- Assessment of the Organization's Ethical Climate

IIA Practice Advisory 2130

Your opportunity



- Only 20% of frauds are revealed by audits
- Yet ordinary people see things every day - right from the start - and they don't like what they see
- The 80% is an opportunity to preempt

If all else fails.....

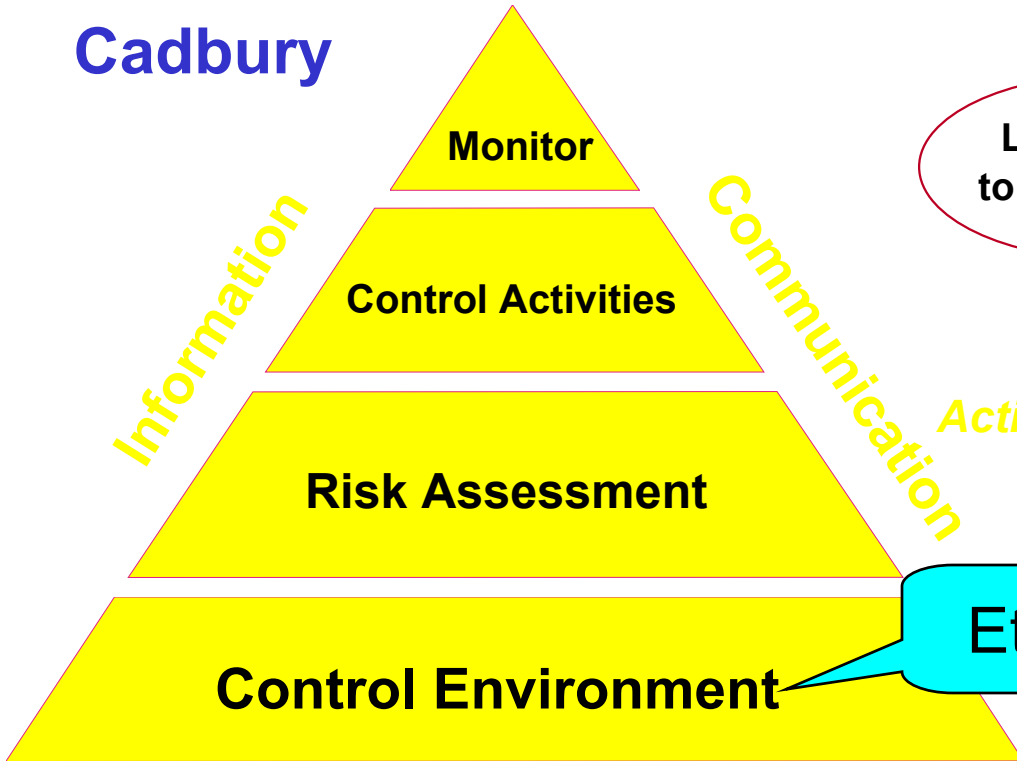




**Your focus is on
people**

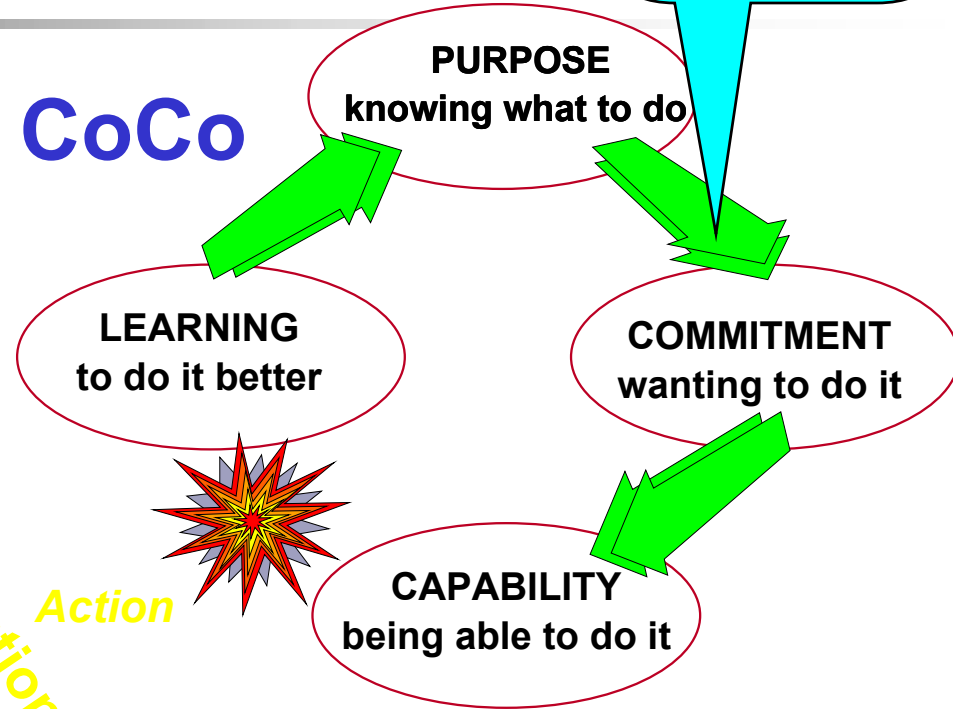
Control Frameworks

**COSO/
Cadbury**



PDK

CoCo





Talk to employees

Too bad nobody talked to WorldCom's employees

Too bad nobody talked to the employees. More than a year ago, dozens of former employees gave statements gathered for a class-action lawsuit launched against the company. They described sales orders that were booked twice, ancient receivables that were listed as assets, payments to suppliers delayed so that profits would look higher and expenses lower. "The allegations were startling in their breadth and detail," says Forbes magazine.

Wall Street Journal/ Forbes

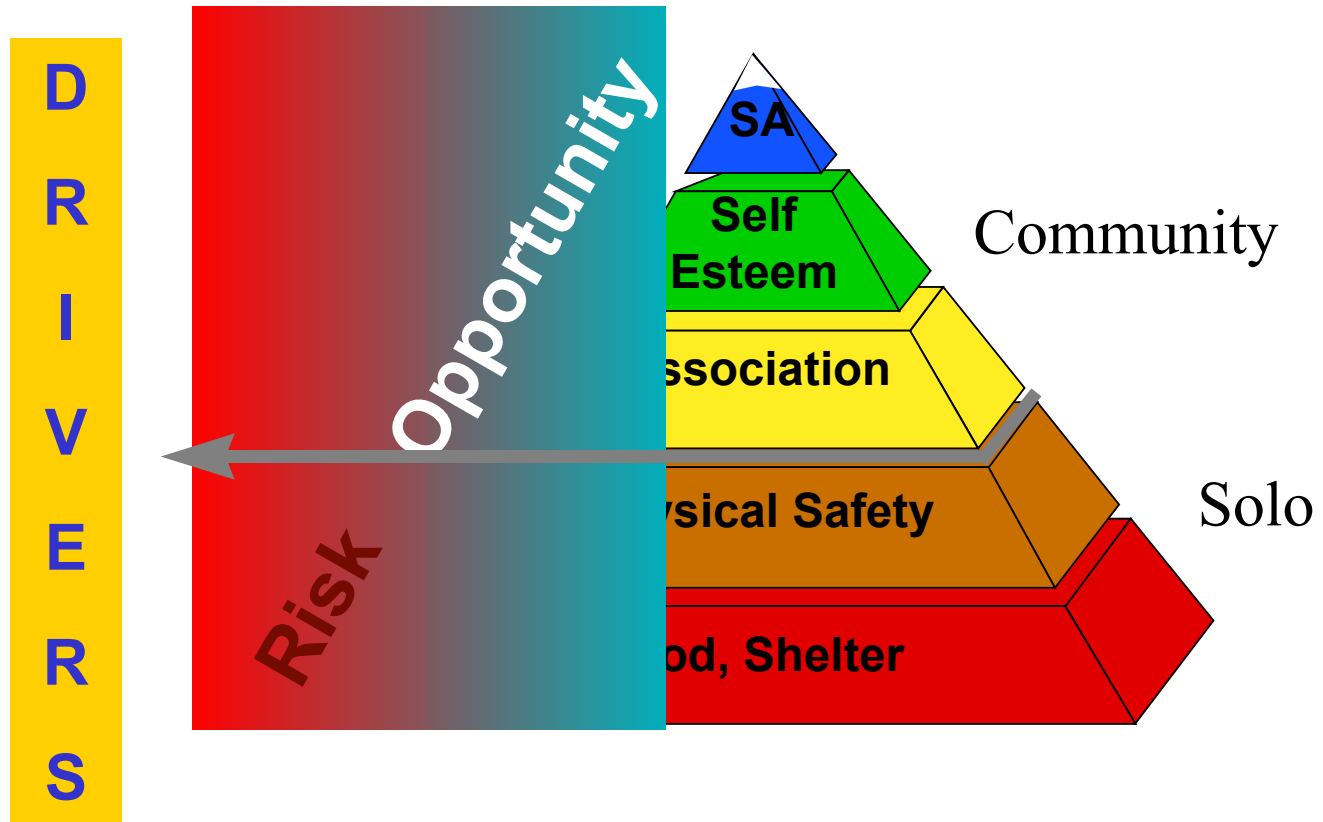


Listen to your people

- People need **open communication** to help deal with ethical dilemmas
- For this they must feel free to talk about concerns **without fear of reprisal**
- Management needs to create a **supportive environment** for this communication to occur

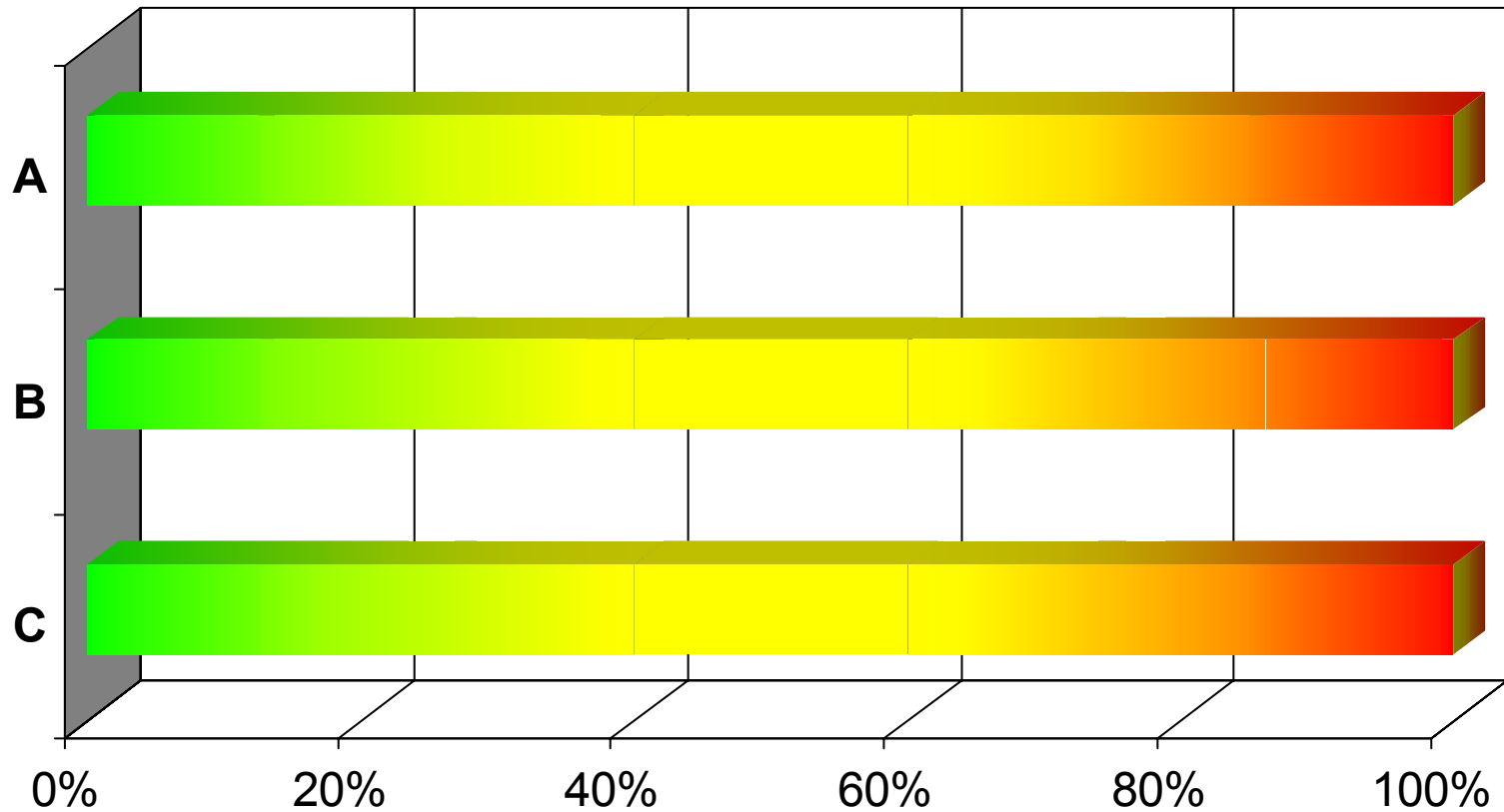
Guidance on Control, Criteria of Control Board, CICA

Personal ethics vary

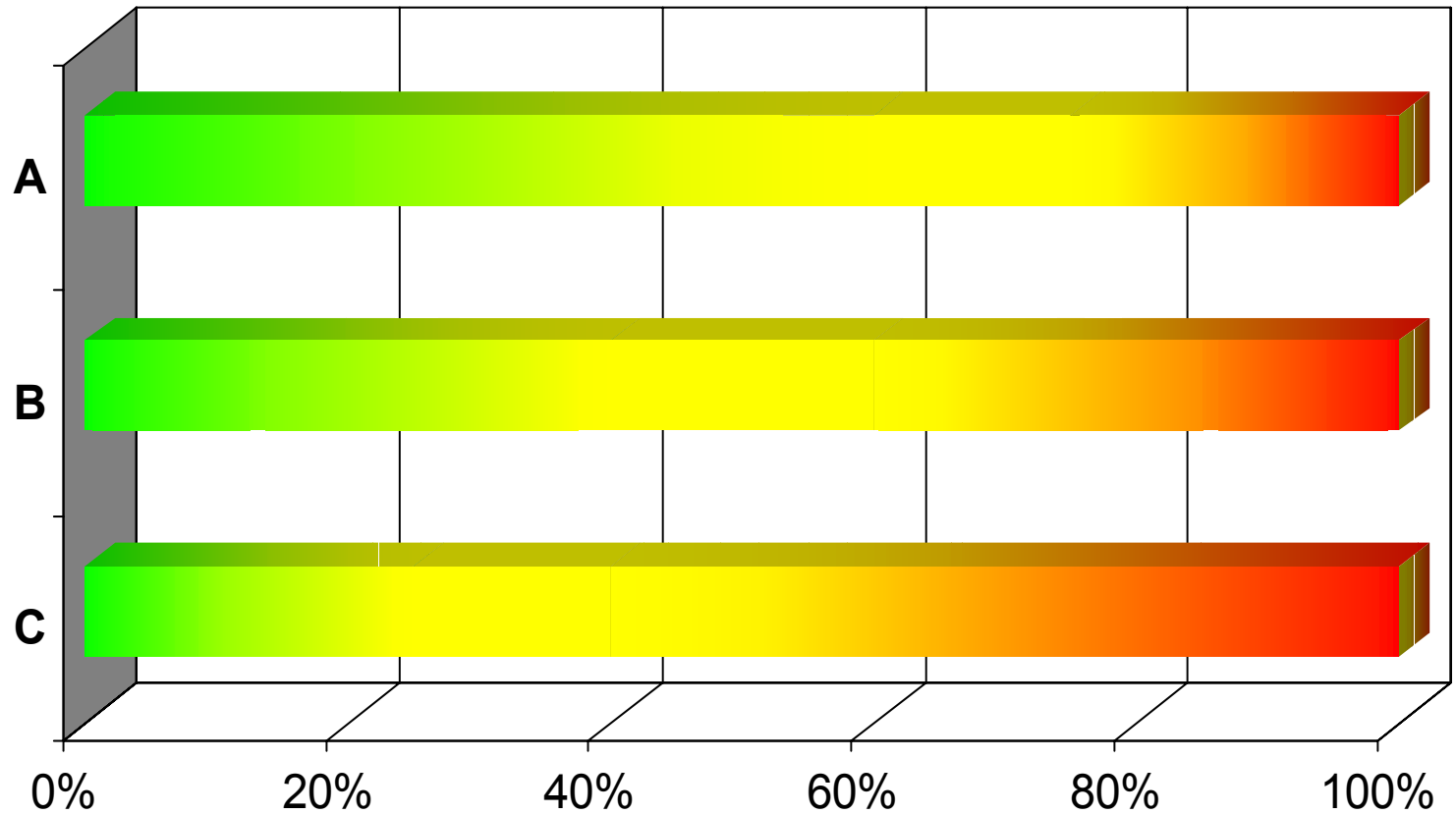


Maslow's Hierarchy of Needs

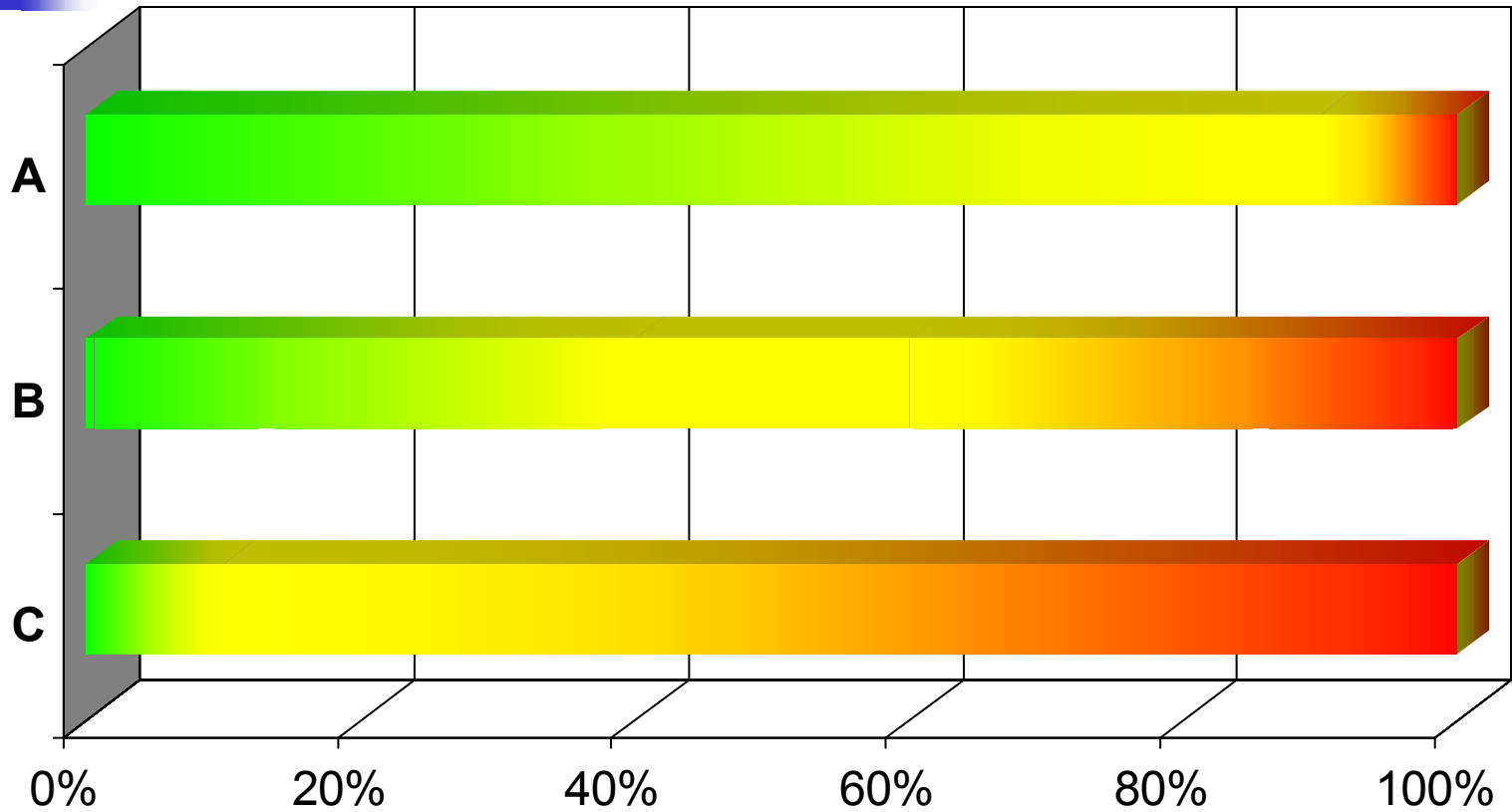
Normal people/organizations



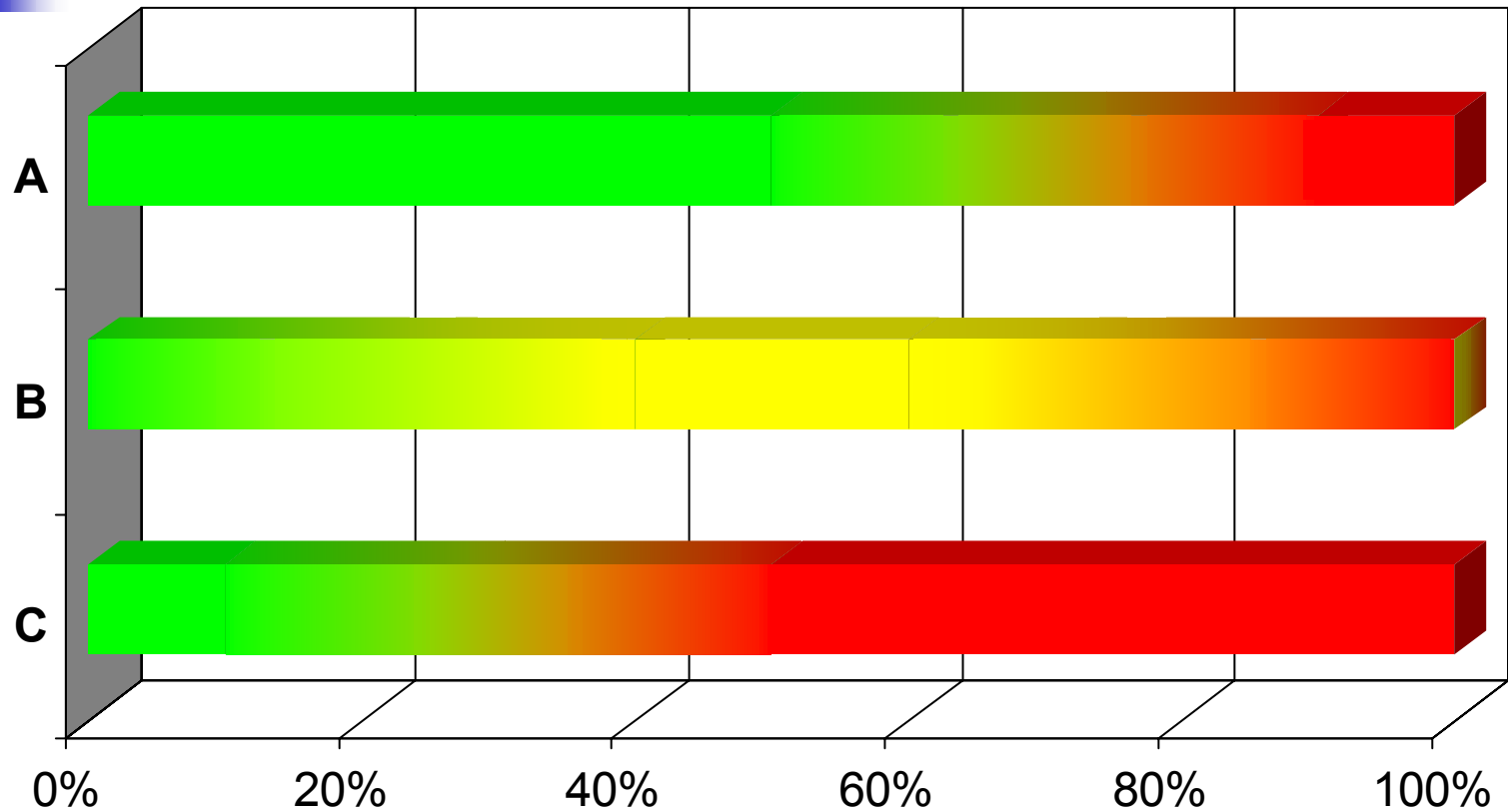
Change is gradual

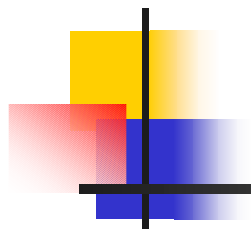


High road or low road?



A robust; B at risk; C too late





Matching community expectations

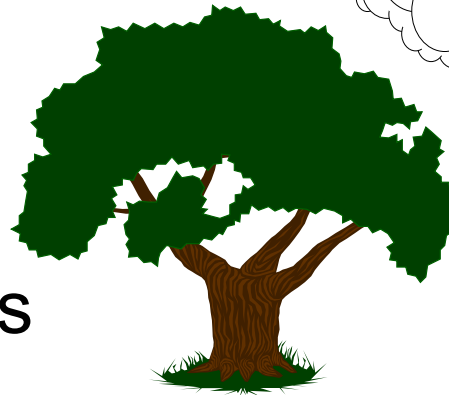
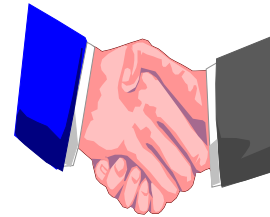
Ethics and Communities

- Ethics are principles of behavior regarded as desirable by the majority of the population in a community
- Ethics vary by:
 - location
 - time
 - religion
 - community



Communities

- Community values
 - which communities?
 - compatibility
- Corporate values
- Personal values
- Leadership
- Secondary impacts





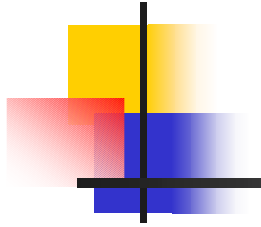
Classic Approaches

- **Utilitarianism** (an objective principle)
 - Do what creates the greatest good for most
- **Categorical Imperative** (rules rule OK?)
 - Set and follow the rules you want everyone to follow
- **Golden Rule** (a subjective principle)
 - Treat others as you would want to be treated



Utilitarianism at work

- A prince, in order to keep his subjects united and faithful, must not mind incurring the accusation of being cruel. For, with very few exceptions, he will turn out to be more merciful than those who, from excessive gentleness, allow disorders to arise, resulting in bloodshed and robbery. As a rule, such evils harm the whole community, while executions by the prince harm only individuals.



Management, the usual suspects

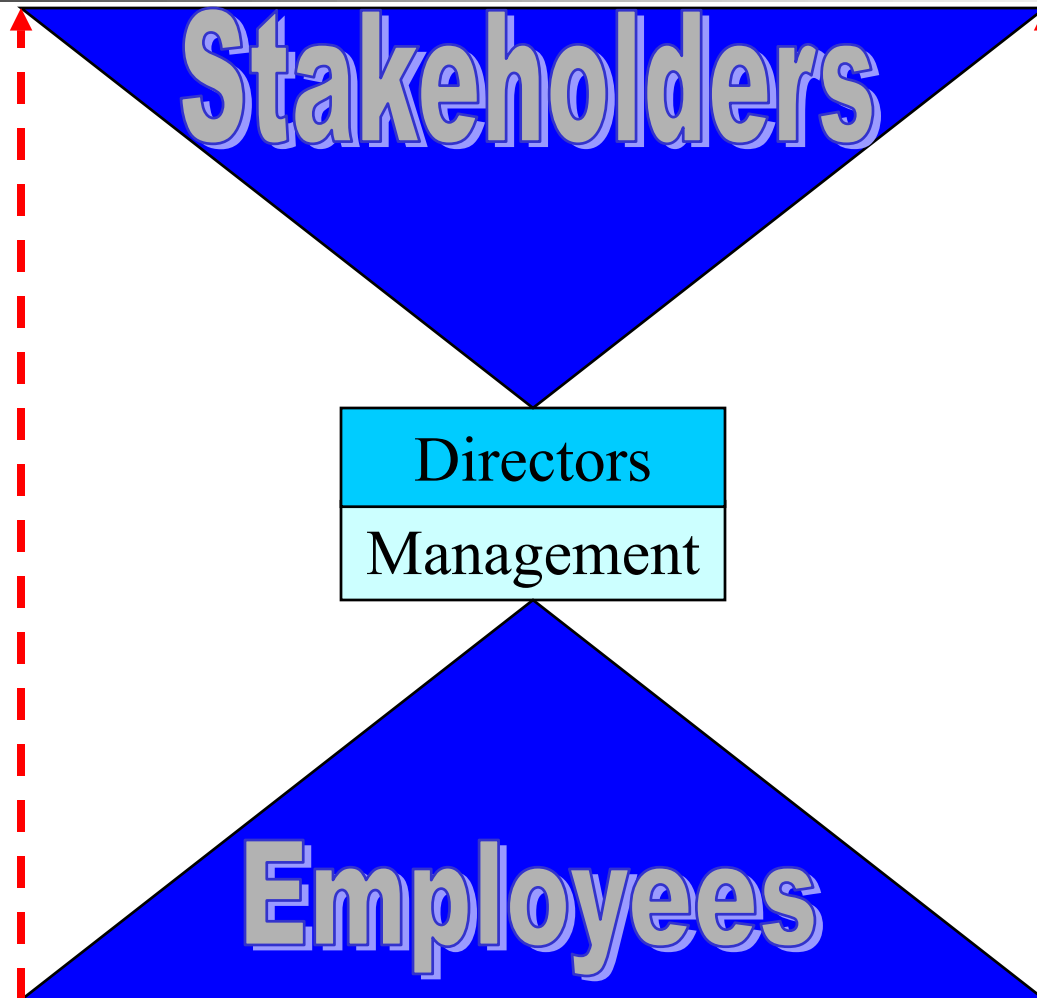


IIA on Governance

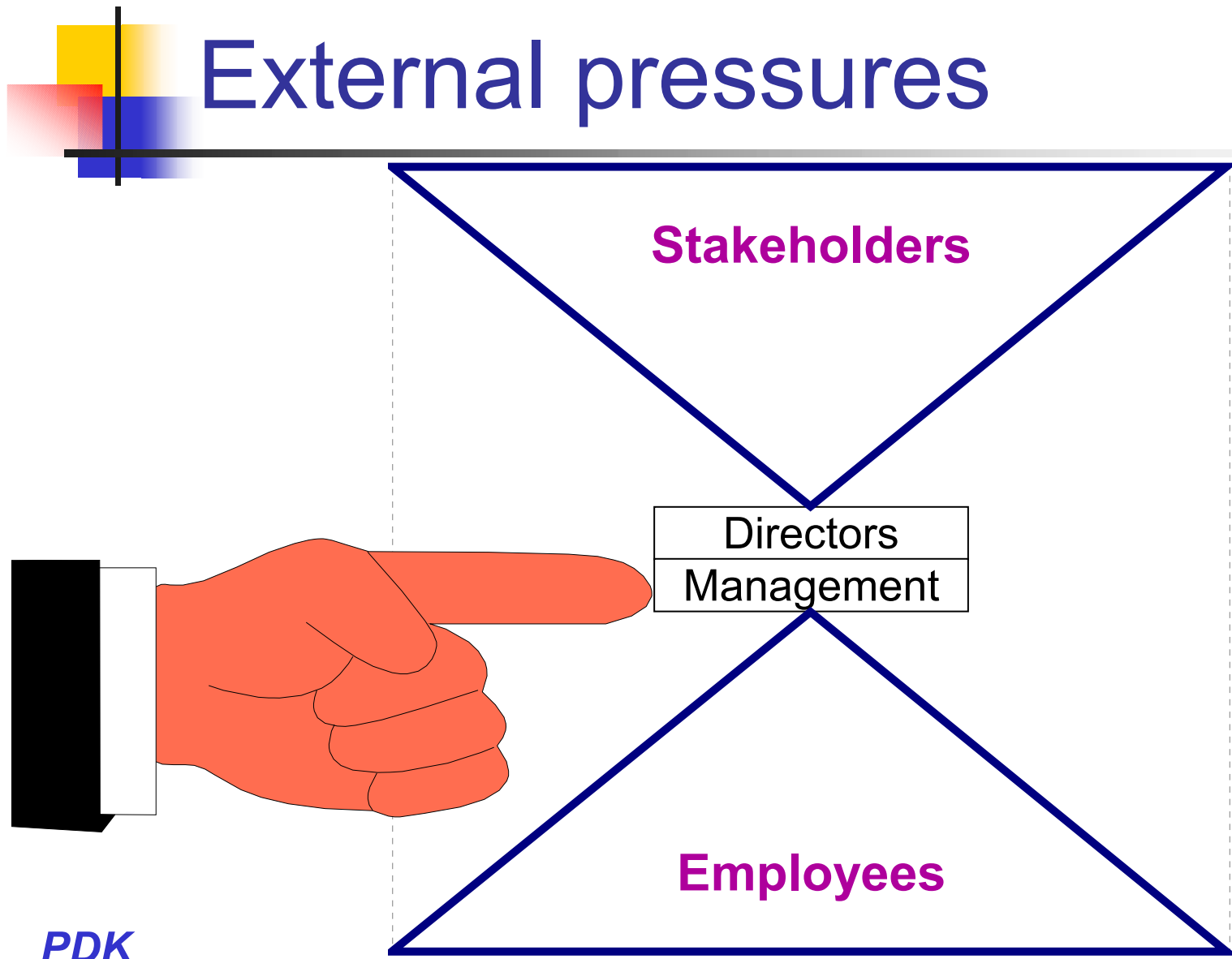
- The internal auditing activity should contribute to the organization's governance process by evaluating and improving the process through which:
 - values and goals are established, shared
 - accomplishment of goals is monitored
 - accountability is ensured
 - values are preserved

IIA Standard 2130

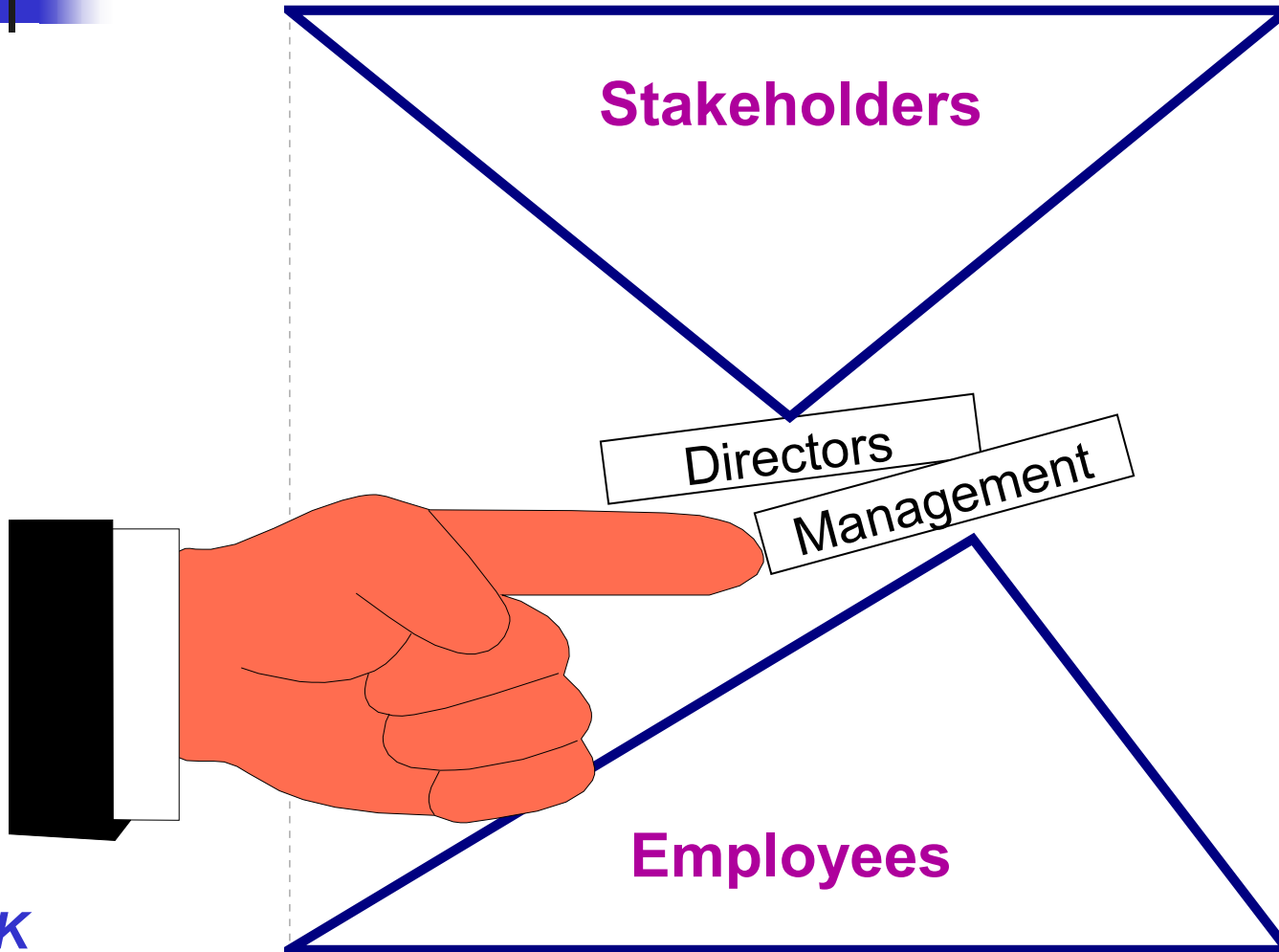
Governance



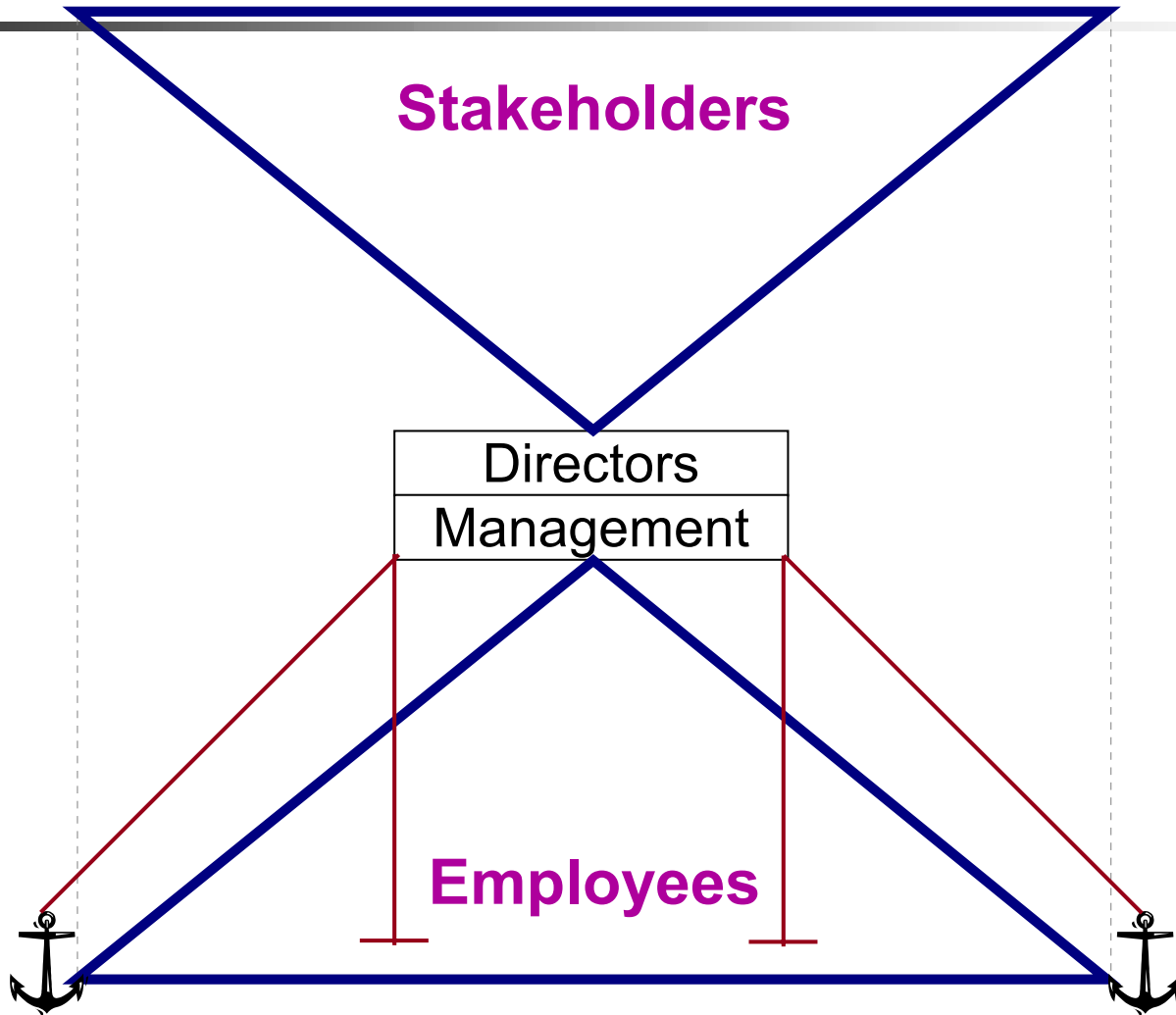
External pressures

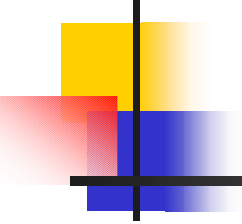


Leadership collapse



Anchors





Building up your Immune system



How vaccination works

- Inject a serum similar to the real virus
- The body's immune system sees the intruder and develops antibodies
- Note you just made one small injection - the antibodies replicated themselves.
- For 95% of individuals the antibodies will successfully smother the Real virus



Some signs of healthy ethics

- Leaders talk ethics and walk the talk
- Employees talk about ethics
- It's OK to challenge new ideas
- Failures have repercussions
- Breakdowns are discussed openly
- Good examples are highlighted
- Personal and corporate values align



Your immunization tools

- Control frameworks
- ESA workshops (**diagnosis, vaccination**)
 - vote on and discuss ethics indicators
 - discuss dilemmas
- Ethics surveys
- Advocacy, leadership opportunities
- Hot line

Run ethics self assessment - ESA

- Facilitate workshops
- Debate dilemmas
- Survey staff and stakeholders on ethics
- Listen actively
- Discuss hot issues with management
- Be a leader





What to look for

Code of Conduct

Open Communication

Support strategies

Programs

Leaders walk the talk

Follow up on issues raised

Effective reporting mechanisms

Learning opportunities

Regular declaration

Internal/external surveys

Positive personnel practices

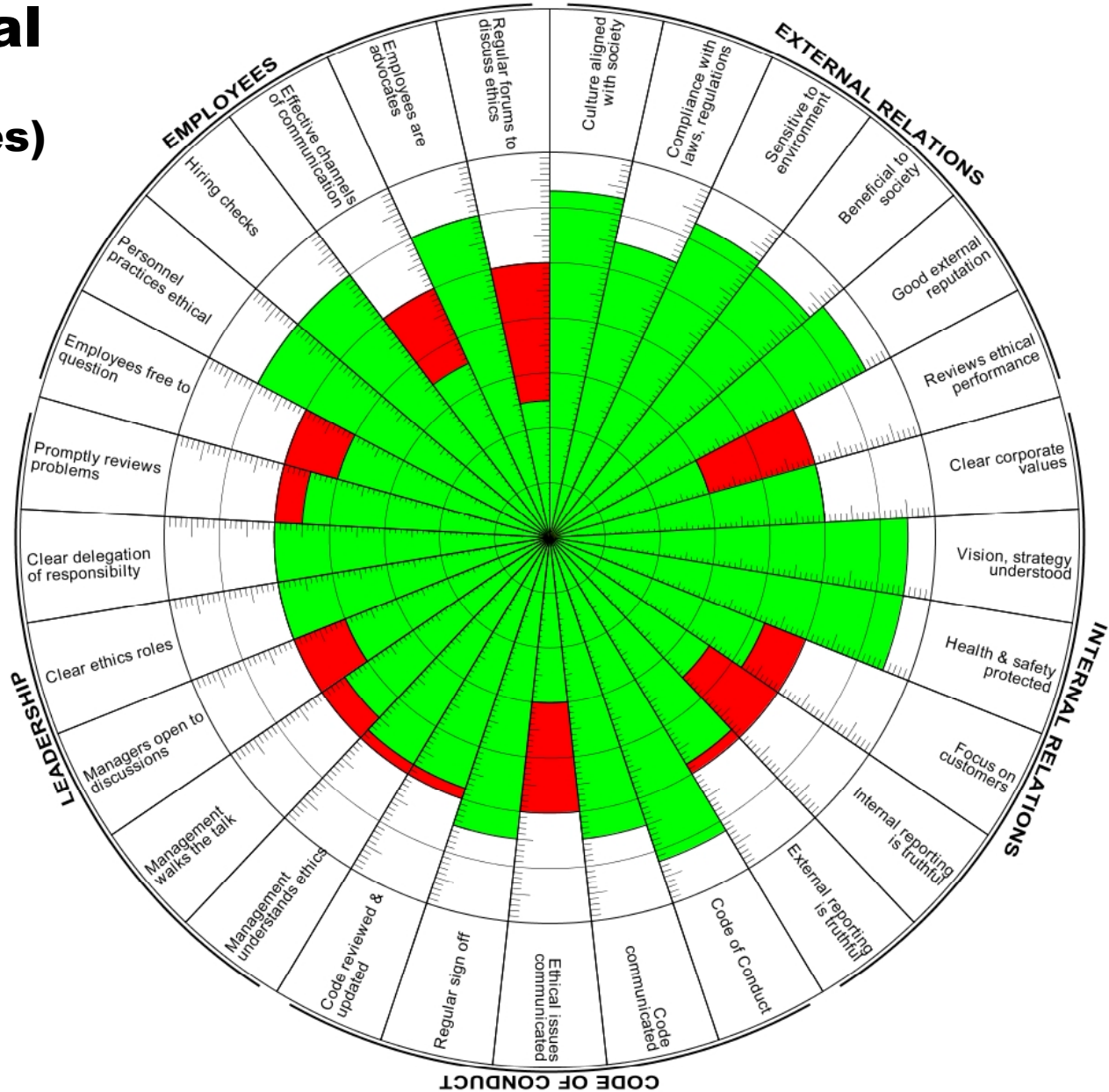
Clear delegation

Regular process reviews

Hiring checks

Ethics Radial

(based on ESA voting responses)





On stage dilemma

- Your team is surprised when your VP comes in one day and asks you all to move down to the 12th floor for a couple of hours. The space is set up to look like traders' desks. He asks you to pretend to be traders while he brings through some prospective clients he'd like to impress.



Your first reaction

- A - Great - 2 hours off work!
- B - I always wanted to be on stage
- C - This seems pretty weird
- D - Is this an honest way to do business?
- E - Something else



You decide to:

- A** - Cancel appointments for the 2 hours
- B** - Act as well as you can
- C** - Ask your VP why you need to do this
- D** - Refuse
- E** - Call the hot line
- F** - Think of something else



Building an Ethics program

- Top management must be engaged
- Involve employees at all levels
- Project team (not HR) prepare a draft
- Employees invited to participate
- Publish comments, rationale
- Management commitment, sign-off
- Board input, final sign-off

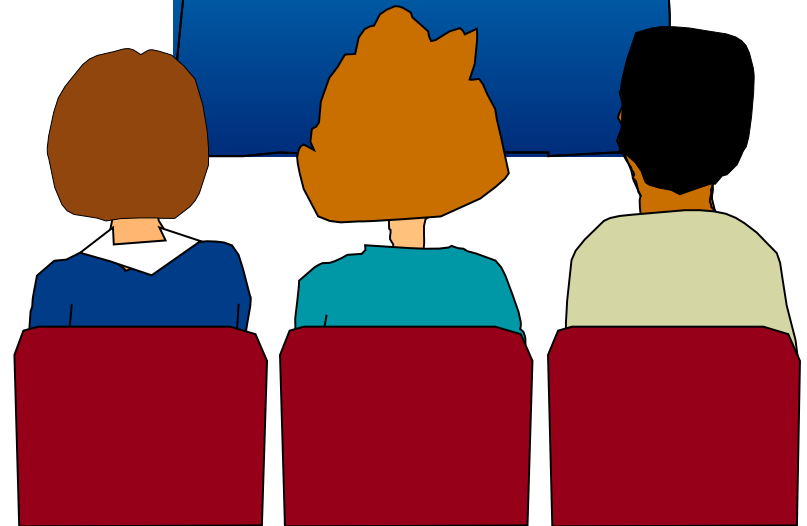


Maintaining an Ethics program

- Same principles as building
 - top management engaged, discuss ethics
 - employee involvement
 - publish results, ideas, examples
- Auditors stay in touch with people
 - face to face is always best
 - surveys are useful

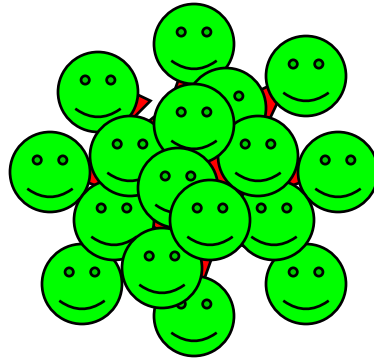
When you are immune

- When individual people (cells or nuclei) become aware and involved,
- they spot the wrong value as it emerges,
- they neutralize it,
- and it fades away.





What immunity looks like



A lot of happy faces



Contact information

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- E-mail - [pmakosz @csa-pdk.com](mailto:pmakosz@csa-pdk.com)
- IIA examples - gscalabre@theiia.org
- For assessing ethics attend the IIA ERCSA conference later this year - it will focus on this issue