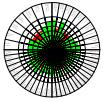


## Ethics in 2003

*a new world for auditors and directors*



Paul Makosz  
Chair IIA International Ethics Committee  
Chief Executive Officer, PDK

**PDK** Control Consulting  
International Ltd.

---

---

---

---

---

---

---

---

## topics

- Systemic breakdown & root causes
- Reaction
- The New World post Sarbanes Oxley
- Ethics and the role of internal audit
- Immunizing your organization

---

---

---

---

---

---

---

---

## Systemic breakdown & root causes

---

---

---

---

---

---

---

---

## Enron root causes

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

Enron  
workers  
lived on  
the edge

Corporate Vill  
Behind Enron's Fall:  
A Culture of Operating  
Outside Public's View  
Hills Donk With Offshore  
And Mutual Disclosure  
Finally Crack In The Trust  
Chester and J&J's Whistles

Enron Official Tells of 'Arrogant' Culture

WSJ - Feb 15/02

PDK

4

---

---

---

---

---

---

---

---

## The Collaborators

- Accountants
- Bankers
- Stockbroker Analysts
- Lawyers
- Government
- Directors
- Other "bright sparks"



PDK

5

---

---

---

---

---

---

---

---

## 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*

PDK

6

---

---

---

---

---

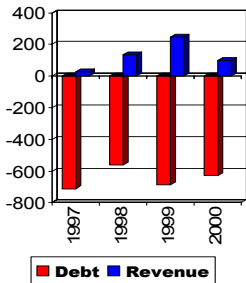
---

---

---

## Ethics and concealment - 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"
- House of cards



PDK

7

---

---

---

---

---

---

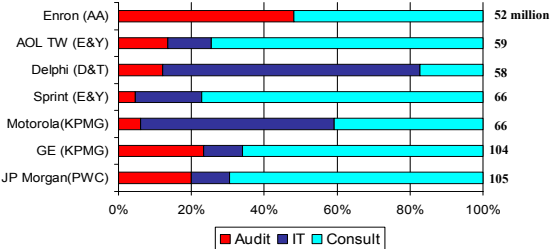
---

---

---

---

## Auditor conflict of interest



PDK

Source - Wall Street Journal and Proxy Filings

8

---

---

---

---

---

---

---

---

---

---

## Missing the point - "F" grade

- 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.

PDK

9

---

---

---

---

---

---

---

---

---

---

## 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

PDK 10

---

---

---

---

---

---

---

---

## 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
- Management making tens of millions in options - employees, small investors lose
- Auditors colluded or failed to detect grossly fraudulent activity

PDK 11

---

---

---

---

---

---

---

---

## Is this a systemic virus?

Healthcare South

JP Morgan      Merrill Lynch

Enron      Conseco      Tyco

Global Crossing      Credit Suisse FB

Citigroup      Arthur Andersen      Qwest      Adelphia

El Paso      Homestore      AON      Xerox

Dynegy      KPMG      KMart

Salomon      AOL Time Warner      WorldCom

Williams Companies      Ahold

PDK 12

---

---

---


---

---

---

---

---



---

# Reaction

PDK 13

---

---

---


---

---

---

---

---

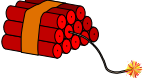


---

## A clear and present danger

- "The sheer number and magnitude of breakdowns that have increasingly become the daily fare of the business press pose a clear and present danger to the effectiveness and efficiency of capital markets in which the United States has taken so much pride."

*Paul Volcker  
May 18, 2002 (NYT)*



PDK 14

---

---

---


---

---

---

---

---



---

## Revenge

"Jail 'em if they're guilty. All the Enron and Arthur Andersen principals and then some. Why? To save our system of corporate governance, which used to be the best in the world. To save investor confidence. Maybe even to save our entire free-market system of capitalism."

*Kudlow, Washington Times, February 2002*

PDK 15

---

---

---

---

---

---

---

---

## The crime statistics

Improper Revenue Recognition	126
Improper Expense Recognition	101
Improper accounting in connection with business combinations	23
Other accounting and reporting issues: MD&A, related party transactions, non-monetary and roundtrip transactions, off-balance sheet, and non GAAP measures	130

PDK

16

---

---

---

---

---

---

---

---

---

---

## The culprits

- The majority of persons held responsible for the accounting violations were members of issuer **senior management**.
- 157 of the 227 matters involved charges against at least 1 senior manager:
  - 75 Chairmen of the Board, 111 CEOs, 111 Presidents, 105 CFOs, 21 COOs, 16 CAOs, and 27 VPs

PDK

17

---

---

---

---

---

---

---

---

---

---

### Settlement Scoreboard: What Each Firm Will Pay

As announced yesterday by regulators, here are the payments by each of the 10 securities firms in the global stock-research settlement. Amounts in millions.



\*Priority debts in prior settlements of single research-asset conflicts

Source: Securities and Exchange Commission settlement documents, the companies

WSJ - Apr 29/03

PDK

18

---

---

---

---

---


---

---

---

---

---



## Sarbanes-Oxley

- Officers sign-off on financials and controls
- Audit committee independent, financially literate
- External auditors lose consulting to audit clients
- No misleading the auditors or omitting significant facts
- Analysts reviewed
- Insiders regulated
- PCAOB
- 10 to 25 years jail
- Whistleblowers protected

*PDK* 19

---

---

---

---

---

---

---

---



## New Regulation Canada

- Saucier Report (November 2001)
- Corporate Public Accountability Board
- CICA ([www.cica.ca](http://www.cica.ca))
  - Accounting Standards Board (SPE and G'tee)
  - Public Interest and Integrity Committee (ED)
- May 2003 "closer to Sarbanes-Oxley"

*PDK* 20

---

---

---

---

---

---

---

---



## The new world Governance

*PDK* 21

---

---

---

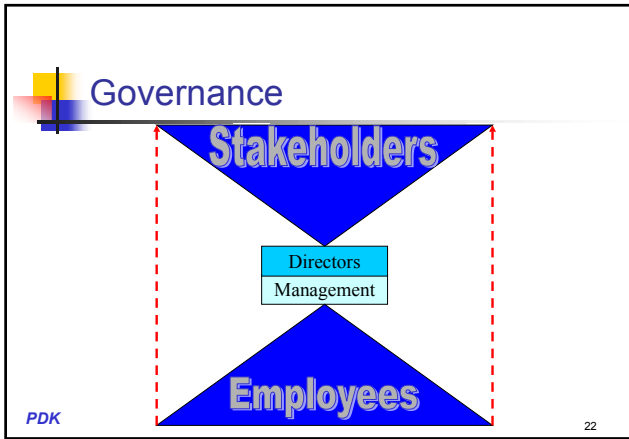
---

---

---

---

---




---

---

---

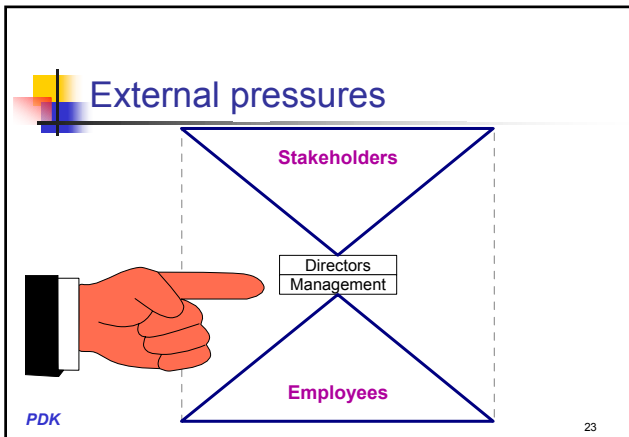
---

---

---

---

---




---

---

---

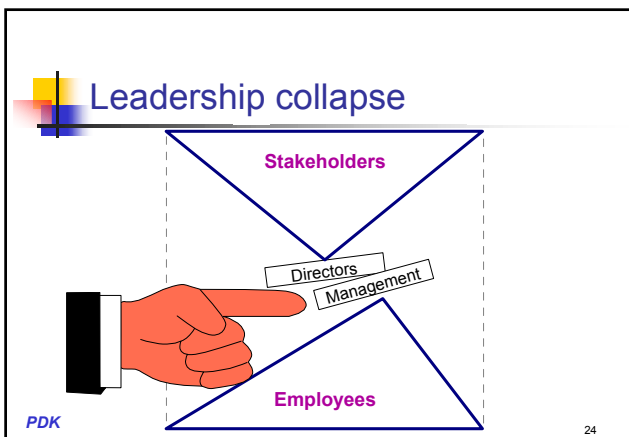
---

---

---

---

---




---

---

---

---

---

---

---

---



**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*

PDK 25

---

---

---

---

---

---

---

---

**The new world  
Audit Committees**

PDK 26

---

---

---

---

---

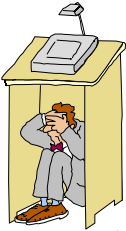
---

---

---

**AC Exposures**

- Ignorance
- Incompetence
- Lack of common sense
- Failure to comply
- Manipulation
- Management deception



PDK 27

---

---

---

---

---

---

---

---

## AC Fears

- How does this committee function?
- Do I understand this business?
- Who, what can I trust?
- Will I have the time I need to prepare?
- How can I see into this organization?
- Embarrassment, loss of reputation
- Liability

PDK 28

---

---

---

---

---


---

---

---

## Common sense requirements

- Business experience, competence
- Intuitive understanding of people
- Healthy skepticism, independence
- Financial literacy
- Window into the organization
- Time
- Budget



PDK

---

---

---

---

---


---

---

---

## SOX challenges for the AC

- Understand full scope of internal control
- Financial literacy
- Scrupulous disclosure
- External auditor fees and consulting
- Complaints, whistleblowing channels
- Internal audit capacity, closeness
- Jail and/or \$ multi-million fines



PDK

---

---

---

---

---

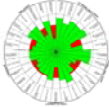
---

---

---

## Internal Auditors, Controllers

- Anticipate their needs for information and offer training
- Give them time to absorb key information
- Try to resolve differences with management before going to them
- Keep reports frank, concise and graphic



PDK 31

---

---

---

---

---

---

---

---

## PDK advice to the AC

- Financial literacy is not nearly enough
- Understand COSO, especially **informal control**, thoroughly. Develop questions.
- Ask external and internal auditors how they will get the answers you need
- Insist on efficiency and effectiveness
- Take a hard line on conflict of interest
- Make your internal audit window bigger

PDK 32

---

---

---

---

---

---

---

---

## The new world *External Audit*

PDK 33

---

---

---


---

---

---

---

---



## Changes in External Audit

- SOX compliance
- Forensic component
- COSO is big - more dependency on Internal Audit
- Fees up 50 -100%
- Classify consulting as audit (not good)
- Demand efficiency and effectiveness
- Measure it
- Informal Control is bigger than Compliance
- Reject low value IAD assistance

PDK 34

---

---

---

---

---

---

---

---



## The new world *Internal Audit*

PDK 35

---

---

---


---

---

---

---

---



## Changes in Internal Audit

- Scope of Control
- IA mandate
- Reporting Relationship
- Timeframes - need for continuous monitoring
- Must prioritize on high value - E&E
- Training
  - COSO
  - Self Assessment
  - Ethics
- Outside expert review (not your auditor)
- Open channels to Board, CEO

PDK 36

---

---

---

---

---

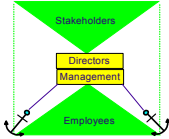
---

---

---

## Last words

- Create and maintain open channels to the AC - on a personal as well as a formal basis
- They are the last line of defence



PDK

37

---

---

---

---

---

---

---

---

## Your role

PDK

38

---

---

---

---

---

---

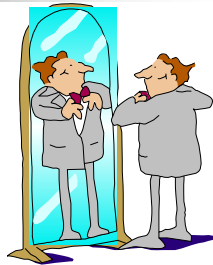
---

---

## Your role

- Everyone else in the game has been tagged and is "out"
- So .....

You're **IT**



PDK

39

---

---

---

---

---

---

---

---

## 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*

PDK

40

---

---

---

---

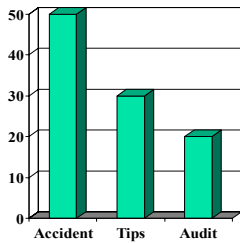
---

---

---

---

## Potential



- 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

PDK

41

---

---

---

---

---

---

---

---

## Focus on people and ethics

PDK

42

---

---

---

---

---

---

---

---

## What we can do

- Focus on people
- Build an auto-immune system
  - Facilitate Ethics Self Assessment
  - Encourage discussion of ethical dilemmas
- Help the Audit Committee
  - Provide a window into the organization
  - Upgrade your skills

PDK

43

---

---

---

---

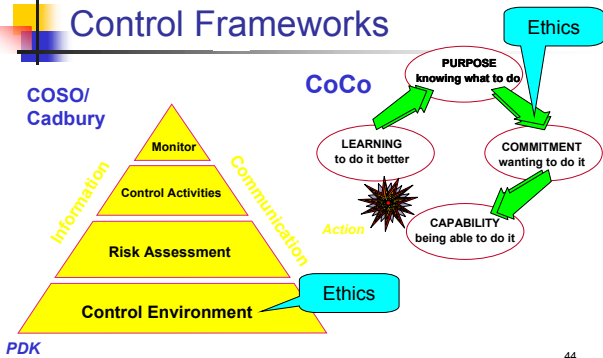
---

---

---

---

## Control Frameworks



PDK

44

---

---

---

---

---

---

---

---

## 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*

PDK

45

---

---

---

---

---

---

---

---

## 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*

PDK

46

---

---

---

---

---

---

---

---

## Ethics and Communities

- Ethics are principles of behavior regarded as desirable by the majority of the population in a community
- Ethics are not fixed. They vary by:
  - location
  - time
  - religion
  - community



They vary by:

PDK

47

---

---

---

---

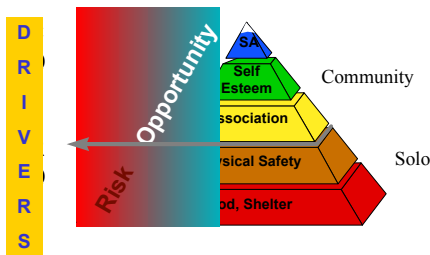
---

---

---

---

## Personal ethics vary



Maslow's Hierarchy of Needs

PDK

48

---

---

---

---

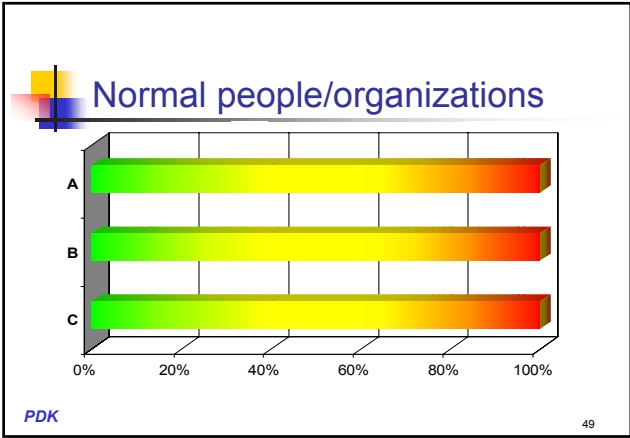
---

---

---

---






---

---

---

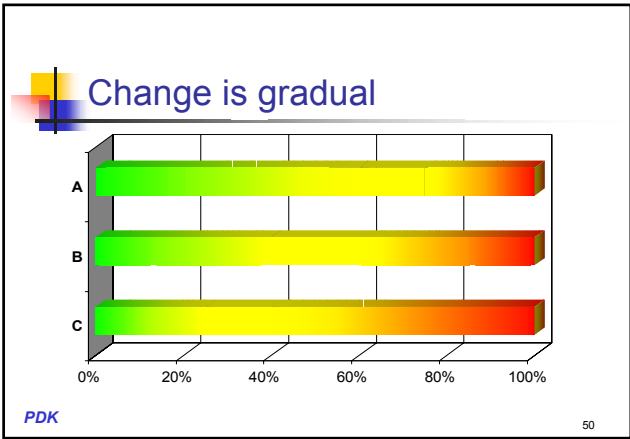
---

---

---

---

---




---

---

---

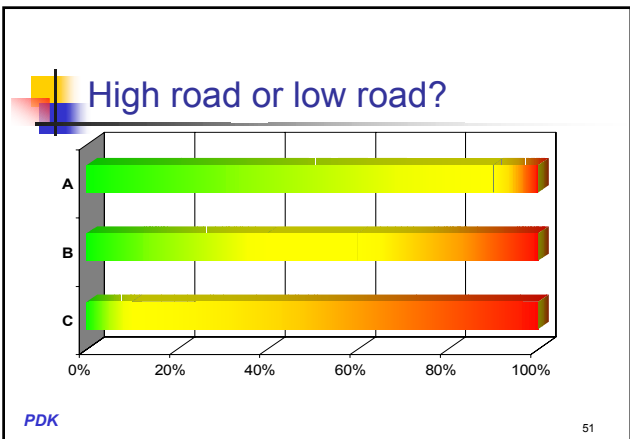
---

---

---

---

---




---

---

---

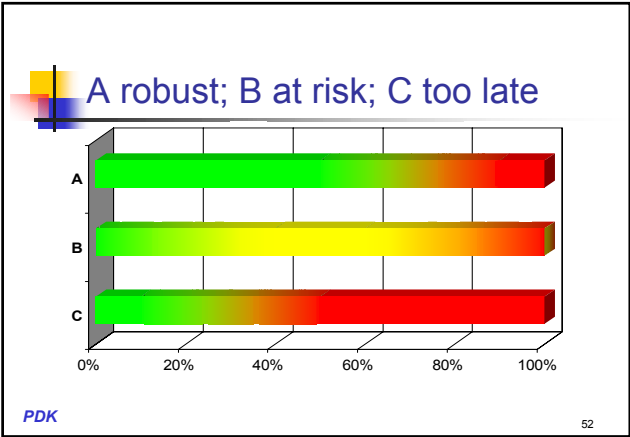
---

---

---

---

---




---

---

---

---

---

---

---

---

## Building an auto-immune system

PDK 53

---

---

---

---

---

---

---

---

- ### 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
- PDK 54

---

---

---

---

---

---

---

---

## 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

PDK 55

---

---

---

---

---

---

---

---

## Your immunization tools

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

PDK 56

---

---

---

---

---


---

---

---

## 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



PDK 57

---

---

---

---

---

---

---

---

## 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

Regular process reviews

Clear delegation

Hiring checks

PDK

58

---

---

---

---

---

---

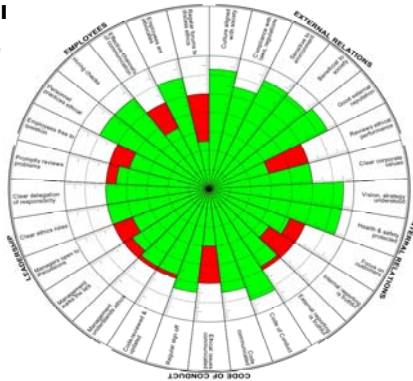
---

---

---

---

## Ethics Radial (based on ESA voting responses)



PDK

59

---

---

---

---

---

---

---

---

---

---

## 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.

PDK

60

---

---

---

---

---


---

---

---

---

---

 **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

PDK 61

---

---

---

---

---

---

---

---

 **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

PDK 62

---

---

---


---

---


---

---

---

 **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



**Good Luck**

PDK 63

---

---

---

---

---

---

---

---