

# Ethics and professional responsibility



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Like most business professions, there has to be a strong sense of ethics and responsibility. Especially professions like law or public accounting. They must have strong standards of integrity. In public accounting, people rely heavily on the information being provided on companies. Any mistakes or intentional cover up will have high costs to the economy and dire consequences.

Even though there are laws and standards that regulate auditing, it does not completely stop or prevent firms from doing immoral acts. Before Sarbanes-Oxley Act of 2002, auditing for both public and privately held companies followed the AICPA's standards of the 10 generally accepted auditing standards. In the years 2000-2002, there had been an increased of major corporate accounting scandals. Large corporations such as Enron and WorldCom went into bankruptcy by trying to cover up their losses and debt. In response to the all the fraud, the US government passed the Sarbanes-Oxley Act. The Sarbanes-Oxley Act created the Public Company Accounting Oversight Board, or PCAOB, and changed how audits of public companies are being done.

The PCAOB adapted the rules and standards of AICPA for auditing and also included auditing of internal control as part of the report, leaving less room for auditors to move around. Here are some of the few companies that led to a drastic change of auditing standards for public companies. Enron was one of the fastest growing American energy company of its time. In the span of 4 years Enron's revenue had increased by over 750 percent. Despite growing at such a rapid pace, Enron filed for bankruptcy the following year. One of the main issues Enron had was independence.

Enron's main auditing firm was Arthur Andersen, however the firm did more than just auditing, they have also provided other non-audit services. This is mostly encouraged by Andersen's compensation policies. The more the non-audit services the auditor can sell in addition with auditing, the more he or she will earn. Also, Duncan, the main partner for Enron with Andersen, developed a close relationship with Enron's Chief Accounting Officer Richard Causey, who also worked for Andersen for almost 9 years.

Because of this, Enron had created a sort of "integrated audit", where the firm who does the internal auditing, also performs the external auditing as well. Andersen has already violated the independence standards on two occasions. Andersen should not be providing any internal auditing services to Enron. Also, they should not place an accountant with a company that has close ties with key figures, such as the Chief Accounting Officer.

All of these led to their independence being impaired. Andersen should have never implemented that compensation policy. The policy only pushed the accountants to do more than what they're allowed to do, causing accountants, like Duncan, to become independence impaired. Even worse Andersen doesn't stop, but continues to strength their relationship between the two companies.

The Fund of Funds was forced into bankruptcy in the 1970s. It was later discovered that King Resources Company, an investment adviser for Fund of Funds, had overcharged FOF for the properties that were sold to FOF. The Fund of Funds sued Andersen for failing to inform them of the overcharges. Arthur Andersen ended up having to pay around \$70 million to FOF.

Both FOF and KRC were audited by Andersen. Andersen viewed KRC as a risk to their firm. John King, the owner of KRC, provided serious difficulties and problems for the auditing firm. The Denver's Andersen office did audit work of NRFA, another investment adviser, for FOF and also auditing KRC. The office was well aware of the relationship between FOF and KRC.

A part of FOF audit scope was to determine the market value of the NRFA interests. However, Andersen did not determine the market value and only review the valuations to see whether it's in accordance with FOF guidelines. Clearly Andersen had an issue with independence because Andersen audited all three companies that had a close relationship with each other. There was a conflict of interest between the FOF and KRC.

Should they have told FOF about the heavy overcharges of the properties being sold from KRF to FOF for the interest of FOF, or kept silent of the matter for the interest of KRC? Andersen had chose the latter choice and got caught in a unfavorable situation. From the very beginning when Andersen found out about FOF and KRC advisory relationship, they should have immediately not accepted to engage with KRC. Auditing for opposing sides can cause serious problems for the firm. The auditing firm will be the first one to be liable for their actions. Either choice would have resulted in a lawsuit with the client.

Both cases of Enron and the Fund of Funds addresses a serious issue with independence. In the AICPA's generally accepted auditing standards, " The auditors must maintain independence in mental attitude in all matters regarding the audit. " Because Andersen had conducted so much non-

auditing services that impaired independence, the Government Accountability Office imposed more restrictive standards on auditor independence. Public accounting firms cannot allow personnel that does the auditing to also work on nonattest engagements for the same client. Also the accounting firms themselves can not perform nonattest services that are significant or material to the subject of the audit. Section 203 of Sarbanes-Oxley further addresses issues of Andersen's independence.

In section 203, it states that it is illegal for the accounting firm to perform audits for the same client for more than 5 years in a row. The professional standards group is a group within Arthur Andersen that conducts reviews on difficult accounting, auditing, and tax issues. The PSG greatly opposed to the accounting issues with Enron. Regardless, their objections were overruled and even one of the members who was against it was removed from the Enron account.

Enron wanted to create a special purpose entity in order to increase their leverage without adding debt to their balance sheets. The PSG disagreed with this move and suggested to not create the SPE. The auditing team said otherwise and allowed the special purpose entity, or LJM, to be made. No matter how many times PSG objected to it, Duncan continued to misrepresent their views and let Enron do as they pleased.

After finding out that there was a considerable large amount of debt that's not being placed on Enron's balance sheet, Andersen still continued to keep Enron as client, mainly due to Duncan's reassurance. Andersen did not provide quality assurance. They did not follow the company's system of audit

checks. The PSG is created for the sole reason of finding any problems arising from the audit with the client. However, no one followed PSG's advice and PSG kept on getting overruled by higher management. PSG should have held a higher power over everything else.

The SARBOX responded to the overruling of opinions and recommendations of accounting and auditing research function with section 103. Instead of overruling the decisions and opinions of research functions such as the professional standards group of Andersen, both groups should be working together in order to address the issues or concerns of the client. The board should cooperate with the advisory groups. Andersen had a document-retention policy, any documents that are not necessary or relevant to the audit file should be disposed of, unless a lawsuit had been filed. After SEC announced an investigation on Enron, Duncan and his audit team started shredding documents from Enron.

They stopped the shredding after Andersen received a subpoena from the SEC. Ultimately, Duncan was fired for shredding the documents and Andersen was charged with the obstruction of justice by disposing the documents relating to the Enron case. The documents should have never been shredded. Duncan only used the document-retention policy as an excuse to cover up the mess, they were only following company's policies after all. In the end that only led to a bigger problem. The document-retention policy should not have been implemented.

It would not given Duncan a chance to try to eliminate the documents. In section 203 of Sarbanes-Oxley Act, firms must maintain the audit paper

works, any other information regarding the audit, and evidence that supports the conclusion for at least 7 years. This is to prevent what had happened in Enron's case with Andersen shredding of important audit documentations.

Waste Management had overstated its reported earnings by \$1.43 billion.

Their management had repeatedly made changes to their depreciation estimates to reduce their expenses and also used improper accounting practices to capitalization policies to also reduce their expenses. Arthur Andersen had performed their audits for Waste Management for over 5 years. Despite Waste Management's misstatements and questionable accounting practices, in 1994 Andersen determined that the misstatements were not material and issued an unqualified opinion. Along with the report, Andersen proposed several adjusting accounting entries and told management to change its accounting practices.

Waste Management failed to go through with either steps several years after, but Andersen still continues to hand out unqualified reports with more proposed adjusting accounting entries. In the end, SEC filed suit against Waste Management's founder and officers. The SEC also brought charges against Andersen for continuing to hand out misleading audit reports for the periods 1993 to 1996. Andersen failed to have due professional care in the preparation of the audit report.

They had knowingly left out material misstatements and misled the public. After the first audit with the material misstatements, knowing that Waste Management had failed to correct their errors and used generally accepted accounting principles, Andersen should have chose not to accept that

engagement. Since both companies had a fairly long relationship with each other, agreeing to accept the engagement and issuing a report other than unqualified might be unacceptable to Waste Management, leading to conflicts of interest and independence impairment. It is better all together to cut off the engagement.

Again, independence reared its ugly head into the situation. In the case with Waste Management and Andersen, the firm had audited the company continuously every year for far too long. The government passed the Sarbanes-Oxley Act, part of which concentrates on independence and conflicts of interest. With independence, a firm should not audit the same client for more than 5 years in a row.

In Waste Management, every chief financial officer and chief accounting officer had previously worked as an auditor at Andersen, creating a conflict of interest. In response to that, Section 206 states that any former chief officers of the client should not be employed by the public auditing firm to audit that same client. WorldCom after filing for bankruptcy, it has been revealed that their revenue was overstated by at least \$958 million and understated line costs by over \$7 billion by using improper accounting. Even though Arthur Andersen had determined that WorldCom's revenue and expenses were not correctly reported, they were not able to collect enough evidence to locate the improper accounting. WorldCom had apparently restricted Andersen heavily. A lot of information asked by Andersen were not provided.



Andersen did not have access to WorldCom's computerized reporting system. No one was allowed to speak or have any interactions with the auditors. Andersen did consider WorldCom a maximum risk client but relied mostly substantive analytical procedures. Also, they did not have the element of surprise since the auditors provided the a list of auditing procedures to be performed to WorldCom's senior management. Substantive analytical procedures should never replace evidence. Andersen should had included in the report that their access to information and ability to collect proper evidence was heavily restricted.

Also, it might have been better to not go into an engagement with WorldCom. With that much restrictions and effort to hide information, there is bound to be some sort fraud going on. Sunbeam made Albert J. Duncap CEO of their company in 1996. Even though Duncap is known for drastically cutting costs with his aggressive measures, Sunbeam had a worse than expected loss in 1998. Ultimately Sunbeam fired Duncap and had to restate its financial statements of 1996, 1997, and 1998.

Arthur Andersen, Sunbeam's auditing firm, was charged for recklessly giving out unqualified reports for Sunbeam. Harow, Andersen's partner, knew of the improper restructuring costs, excessive litigation reserves, improper revenue recognition of sale of inventory. Harow had made several proposals to reverse the entries that did not comply with GAAP. Sunbeam refused to do so and Harow went along with it.

Although Harow knew all of the improper accounting, he submitted to Sunbeam's request and continued to give them unqualified opinions on their

financial statements for the 1996 and 1997. Harow had a lack of due professional care. He failed to approach the audit with diligence. In spite of finding numerous problems with accounting entries not following generally accepted accounting principles, he still gave out unqualified opinions.

Harow should have been more firm with his decisions and not back down so easily to Sunbeam. This is one of the causes that led to the creation of Audit Committees. Audit Committees is composed of at least three independent outside directors that are directly responsible for appointing, compensating, and overseeing the public accounting firm. If any problems or concerns arises from the audit process due to fraud or risks, auditors must bring this issue up with the Audit Committee.

The following case took place after the Sarbanes-Oxley Act was passed. This is a clear example of how even with rules in place, there will be some that will not follow it. Ethics is all based on the person, whether or not they chose to follow with it. Bernie Madoff is well known for defrauding investors. Madoff made up an innovative “ split-strike conversion strategy” to trick people into believing that he had discovered a way to invest their money in securities that would generate a large amount of profit.

Madoff never invested the money in securities, instead he deposited the money into a bank account at Chase Manhattan Bank. Bernard L. Madoff Investment and Securities’ financial statements were audited by Friebling ; Horowitz. David Friebling was arrested for aiding with Madoff’s investment advisor fraud and filing false audit reports with SEC. Friebling failed to verified BLMIS revenues, assets, liabilities related to BLMIS client accounts.

Friechling did not test internal controls on payment of invoice for corporate expenses or the purchase of securities by BLMIS for their clients. Friechling did not exercise due care and maintain professional skepticism throughout the audit. Friechling had intentionally gone along with Madoff's ponzi scheme. He should have been well aware of what he was getting into. Despite the risks, he continued to work with Madoff, probably due large compensation incentives.

Upon auditing Madoff's business and discovering the fraud, the auditors should have immediately backed away and withdraw from the engagement. In response to the Ponzi scheme, financial statements of all nonpublic broker-dealers for fiscal years ending after December 31, 2008, will be subjected to PCAOB oversight. Also SEC proposed that all investment advisers who have custody of customer assets undergo unannounced surprise annual audits. Beginning in January 1, 2012, New York firms with three or more accounting professionals will be subjected to peer reviews once every three years. All the cases above more or less led up to the creation of the Sarbanes-Oxley Act of 2002. Majority of the firms had problems with independence and conflicts of interest.

The act did its best to prevent such events from happening again, but not everyone will abide by the laws or rules imposed on them. No matter how much restrictions are in placed, fraud and scandals are still hard to find unless companies are investigated thoroughly. Regardless, ethical and professional responsibilities will always be stressed in any occupation. Morally acting in the best interest of the public is the right thing to do.

Laws and regulation will continue to adapt to changes and issues in order to protect the public. The Sarbanes-Oxley Act and PCAOB had done well so far and will continue to until a new change is brought about by another series of frauds and scandals.