

PROFESSIONAL ETHICS – CASES “WORLDCOM” AND “KOGER PROPERTIES”

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WORLD COM CASE 3.4

Agenda

- Introduction to case 3.4 – “WorldCom – The story of a Whistleblower”
 - Summary of WorldCom Case
 - Sarbanes - Oxley Act of 2002 Section 301.4
 - Whistleblower processes
 - **Key characteristics for a effective corporate whistleblower hotline**
 - **Potencial pitfalls**
 - Professional standards of the Institute of Internal Auditors - For a effective internal audit function
 - Disclosure Required by Sections 406 and 407 of the Sarbanes - Oxley Act of 2002
 - Whistleblowers Obstacles
 - Characteristics for being an effective whistleblower
 - Sarbanes - Oxley Act of 2002 Section 302

Summary of WorldCom Case

- Cynthia Cooper - typical accounting person, with master in Accounting and with certified public accountant
- Joined Long Distance Discount Service (LDDS) which later became known as WorldCom, as a consultant in the finance department.
- Later, started to head up it's internal audit department in the mid-1990s. She was promoted to Vice President of Internal Audit in 1999.
- WorldCom began as a small Mississippi provider of long distance telephone service called LDDS
- The company became the 25th largest company in the United States. WorldCom's stock price continued to rise through 2000
- The telecom market was saturated by 2001 and WorldCom's earnings began to fall.

What happened?

WorldCom Leadership

CEO – Bernie Ebbers



CFO – Scott Sullivan



How it started?

- WorldCom and other telecommunications firms have faced reduced demand and the economy entered recession.
- Revenues fall short of expectations, while debt remained
- Profits Market value of the company's common stock started also to decrease

FRAUD

- Cynthia discovered that the company erroneously capitalized billions of dollars of network lease operating expenses as assets on WorldCom's books. This allowed the company to report a profit of \$2.4 billion instead of a \$662 million loss.
- The fraud was simple, the corporate accounting team led by Sullivan had merely transferred normal operating lease expenses to the balance sheet as an asset.

FRAUD was accomplished basically by two ways:

- WorldCom's accounting department underreported 'line costs'
- The company inflated revenues with bogus accounting entries from corporate unallocated revenue accounts.

What WorldCom tried to do?

- ➔ Reduced the amount of money held in reserve and moved this money into the revenue line of its financial statements.
- ➔ Classified operating expenses as long-term capital investments



These changes turned WorldCom's losses into profits
Made WorldCom's assets appear more valuable.

Sarbanes – Oxley Act of 2002 Section 301.4

SEC. 301. PUBLIC COMPANY AUDIT COMMITTEES

(4) COMPLAINTS — Each audit committee shall establish procedures for— “(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters”; and “(B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.”

Also addresses the commitment of the Company to integrity and ethical behavior by helping to foster and maintain an environment where Associates can act appropriately, without fear of retaliation.



Whistleblower Processes

A process that enables individuals to disclose suspected illegal or unethical conduct to appropriate College officials, without fear of reprisal, so that the College can investigate and take corrective action as warranted

Is intended to:

- ❖ Informs individuals how suspected illegal and unethical conduct can be reported;
- ❖ Funnel any such reports into, and does not modify or replace, the existing procedural mechanisms for reviewing and resolving the matters reported;
- ❖ Protects individuals who make such reports in good faith from reprisal by adverse employment action or other forms of retaliation, even if the reports turn out to be erroneous;
- ❖ Prohibits, and allows for disciplinary action for, intentionally false reports;

Whistleblower Processes

Reporting Procedure

Reports of suspected illegal or unethical conduct may (and should) be made to any of the following:

Immediate super visor

College official with compliance oversight responsibility for the relevant issue

General Counsel

Vice President of Human Resources

Controller

Risk and Compliance Director

EthicsPoint Whistleblower Hotline

Reports may be made anonymously, and the EthicsPoint Hotline is specifically designed to accept anonymous reports

Effective corporate whistleblower hotline

- 1 - Hotline as an integral part of company's corporate compliance and ethics program
- 2 - Anonymity and confidentiality
- 3 - No retaliation
- 4 - Whistleblower incentives
- 5 - Positive "tone at the top."
- 6 - Educate, publicize and make hotline available
- 7 - Multiple uses for hotline, including a helpline
- 8 - Record and analyze statistics
- 9 - Benchmark
- 10 - Hotline managed by third-party provider
- 11 - Allow multiple methods for submitting tips
- 12 - Evaluate, test and audit
- 13 - Educate other stakeholders and grant access to hotline

The quality of a company's internal compliance and reporting programs and how effectively they are communicated to employees may significantly impact whether a **whistleblower first reports internally or approaches a regulator, such as the SEC.**



Potencial Pitfalls

What If Someone Uses the Hotline to Make a Malicious or False Report?

- 1 - Interpreting if it is honest or malicious is a vital part of any investigation and can lead to very different outcomes.
- 2 - False report is a violation of the firm's core values, which support the standard of conduct.
- 3 - Document every anonymous communication as evidence and keeping a record of that. This not only helps with the legitimacy of information, it will make the investigator's job much easier.
- 4 - Understanding good faith and protecting a whistleblower.

Professional standards of the Institute of Internal Auditors

As Vice President of Internal Audit, Cynthia Cooper reported directly to WorldCom's CFO, Scott Sullivan, and not to the CEO or audit committee.

She did it right?

For an effective internal audit function:

The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Definition of Internal Auditing, the Code of Ethics, and the Standards. The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.

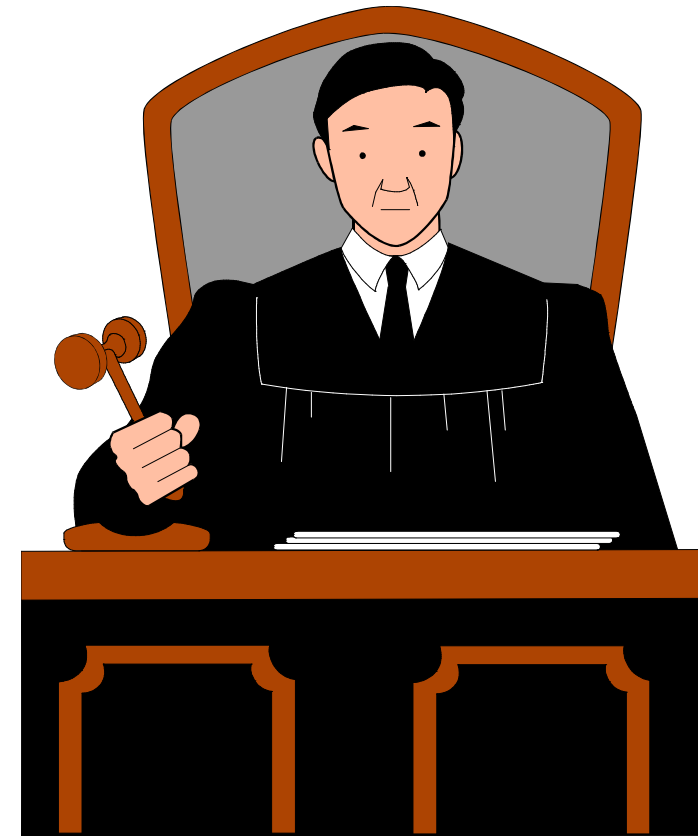
Example: A survey on CFO.com, 38% of CFO's responded "yes" to the following question: "Have you ever engaged in 'aggressive accounting' practices to improve your company's reported financial results?" The large number of 'yes' responses would indicate that some of the control processes relied upon by the audit committee to ensure the adequacy and transparency of financial reporting has been compromised. This is not to say that reporting to a CFO is always a wrong answer. It may work in some cases, but it may also hide information that needs to flow to the audit committee.

Disclosure Required by Sections 406 and 407 of the Sarbanes – Oxley Act of 2002

These rules will require public companies to disclose information about corporate codes of ethics and audit committee financial experts.

Pursuant to Section 407 - a company will be required to annually disclose whether it has at least one "audit committee financial expert" on its audit committee, and if so, the name of the audit committee financial expert and whether the expert is independent of management.

Pursuant to Section 406 - a company will be required to disclose annually whether the company has adopted a code of ethics for the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If it has not, the company will be required to explain why it has not.



Whistleblowers Obstacles

- ❑ Forced to leave organization/demotion
- ❑ Credibility ruined
- ❑ Family, health, and/or life in danger
- ❑ Outrage and divisiveness of people directly or indirectly involved
- ❑ Physical or psychological isolation
- ❑ Organization experiences, productivity, positive reputations fall down
- ❑ Loss of money
- ❑ Incarceration

Seven common mistakes

Seven mistakes are commonly made by those aiming to expose wrongdoing:

- Trusting too much
- Not having enough evidence
- Using the wrong style
- Not waiting for the right opportunity
- Not building support
- Playing the opponent's game
- Not knowing when to stop.

Characteristics for being an effective Whistleblower

Whistleblowing can have devastating consequences for health, finances and relationships. We should take steps to maintain each of them.

- ❖ Altruistically Motivated
- ❖ Utilitarian
- ❖ Uninterested in Altering Their Behavior
- ❖ Allows Own Attitudes and Beliefs to Guide Them
- ❖ Often are Well Educated and Holds Professional Positions

Sarbanes – Oxley Act of 2002 Section 302

Periodic statutory financial reports are to include certifications that:

- ❑ The signing officers have reviewed the report
- ❑ The report doesn't contain any material untrue statements or material omission or be considered misleading
- ❑ The financial statements and related information fairly present the financial condition and the results in all material respects
- ❑ The signing officers are responsible for internal controls and have evaluated these internal controls within the previous ninety days and have reported on their findings
- ❑ A list of all deficiencies in the internal controls and information on any fraud that involves employees who are involved with internal activities
- ❑ Any significant changes in internal controls or related factors that could have a negative impact on the internal controls.



KOGER PROPERTIES CASE 5.5

Agenda

- Introduction to case 5.5 – “Koger Properties, Inc”
 - Summary of Koger Properties
 - The SEC charged that Goodbread violated its independence rules, the AICPA's Code of Professional Conduct, and generally accepted auditing standards.
 - In your opinion, did Goodbread's equity interest in Koger Properties likely qualify as a "material" investment for him? Was the materiality of that investment a relevant issue in this case?
 - Given that Goodbread purchased stock of Koger Properties in 1988, under what conditions, if any, could he have later served as the audit engagement partner for that company?
 - During much of the 19th century in Great Britain, independent auditors were not only allowed to have an equity interest in their clients but were required to invest in their clients in certain circumstances. Would such a rule "make sense" in today's business environment in the United States?

Summary of Koger Properties Case

- Introduction to case 5.5 – “Koger Properties, Inc”
 - Michael Goodbread staked out his career goal four decades ago
 - Goodbread accepted an entry level position with Touche Ross & Company for his 1st step after college
 - Goodbread received his CPA license in February 1973
 - Goodbread became a partner with Deloitte & Touche in December 1989
 - The impressive salaries earned by partners of large international accounting firms, provide Goodbread making investment to the local companies
 - Koger Properties, Inc. caught Goodbread attention during the late 1980
 - In December 1988, Goodbread purchased 400 shares of Koger’s common stock at a price of \$26 per share

Summary of Koger Properties Case

- Introduction to case 5.5 – “Koger Properties, Inc”
 - One of Goodbread's first assignments with his new firm was supervising the audit of Koger Properties for its fiscal year ending March 31, 1990
 - Koger had previously been an audit client of Deloitte, Haskins & Sells. In his role as audit engagement partner, Goodbread oversaw all facets of the Koger audit.
 - In February 21, 1990, Goodbread signed the "audit planning memorandum" that laid out the general strategy Deloitte & Touche intended to follow in completing the Koger audit.
 - Several months later, in June 27, 1990, Goodbread signed the "audit report record" for the Koger engagement. At the time, the signing of that document by the audit engagement partner formally completed a Deloitte & Touche audit.
 - Almost exactly one month earlier, in May 10, 1990, Goodbread had sold the 400 shares of Koger stock that he had owned since December 1988. Goodbread sold the stock at a price of 20.75\$ per share.

The problem

- **The Securities and Exchange Commission (SEC) learned that Goodbread had held an ownership interest in Koger Properties while he supervised the company's 1989 audit.**

Goodbread's ownership interest in Koger violated its independence rules, the Code of Professional Conduct of the American Institute of Certified Public Accountants (AICPA), and generally accepted auditing standards.

Goodbread caused Deloitte & Touche to issue an improper opinion on Koger's 1989 financial statements.

1° Explanation - The SEC charged that Goodbread violated its independence rules, the AICPA's Code of Professional Conduct, and generally accepted auditing standards. Why they made this allegations?

“Independence shall be considered to be impaired if : During the period of the professional engagement a covered member was committed to acquire any direct or material indirect financial interest in the client.” (aicpa.org 101-1)

In Goodbread’s case this refers to the fact that he had shares of stock (direct financial interest) in his possession when he was the audit engagement partner who oversaw the audit of Koger Properties, Inc.

“The auditor must maintain independence in mental attitude in all matters relating to the audit.” GAAS (Generally Accepted Auditing Standards)

Difference between Independence in fact and Independence in appearance

An auditor must not only be independent in fact (objectively), but must also avoid actions that may appear to affect independence.

2° Explanation - Did Goodbread's equity interest in Koger Properties likely qualify as a "material" investment for him? Was the materiality of that investment a relevant issue in this case?

Material interest!!

Rule 2-01(b) of SEC states, *“an accountant will be considered not independent with respect to any person... in which... he, his firm or a member of his firm had, or was committed to acquire, any direct financial interest or any material indirect financial interest...”*

3° Explanation - Given that Goodbread purchased stock of Koger Properties in 1988, under what conditions, if any, could he have later served as the audit engagement partner for that company?

The AICPA Code of Professional Conduct expressly prohibited Goodbread's Koger stock ownership during the time of the Koger audit!

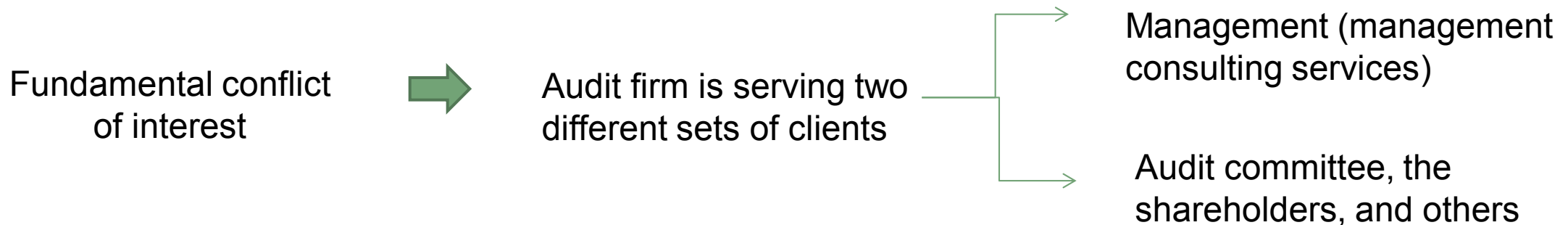
The Code states that *"independence shall be considered to be impaired if... during the period of a professional engagement, or at the time of expressing an opinion, a member or a member's firm... had or was committed to acquire any direct or material indirect financial interest in the enterprise"*.

If an auditor isn't independent, *"any procedures he might perform wouldn't be in accordance with generally accepted auditing standards and he would be stopped from expressing an opinion on such statements."*

4° Explanation -During much of the 19th century in Great Britain, independent auditors were not only allowed to have an equity interest in their clients but were required to invest in their clients in certain circumstances.

Would such a rule "make sense" in today's business environment in the United States?

- Exclusionary rule that would prohibit an audit firm from providing non-audit or non-tax services, except in very limited circumstances, to its public audit clients



Goodbread held a direct ownership interest in Koger stock while participating in the initial phases of the audit of Koger's financial statements

THE END