Ethics: An Overview for Texas CPAs

By Colleen Neuharth McClain, CPA

CPE Edition

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Course Information

Course Title: Ethics: An Overview for Texas CPAs

Learning Objectives:

- Understand the purpose of studying ethics and be excited about the opportunity to improve your ethical reasoning abilities
- Understand the process of ethical reasoning and how to apply it when specific dilemmas occur
- Comprehend the core values of the CPA profession (integrity, objectivity and independence)
- Be familiar with the Texas Rules of Professional Conduct and enforcement actions that the Board has recently made to apply those rules
- Understand the case studies which are presented throughout the course to assist you in maintaining the highest standards of ethical conduct

Subject Area: Ethics

Prerequisites: None

Program Level: Overview

Program Content: This course is designed to meet the 4 hour ethics CPE requirement for Texas. It covers the definition of ethics, ethical reasoning and its application to common dilemmas, the core values of the CPA profession, and the Texas Board Rules of Professional Conduct. This course has been specifically reviewed and approved by the Texas State Board of Public Accountancy. It does not follow the format of most of our CPE courses as it does not include review questions with feedback throughout the material. Review questions and feedback are not required for this course because it has been formally approved (as required) by the Texas State Board in this specific format. Instead, you will find interesting case studies located throughout that demonstrate the subject matter being discussed.

Advance Preparation: None

Recommended CPE Credit: 4 hours

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Chapter 1
Introduction

Subsequent to the collapse of Enron and the controversies surrounding Arthur Andersen, the Texas State Board of Public Accountancy (TSBPA) decided that two hours of board-approved ethics continuing professional education (CPE) each three years was not enough. Beginning January 1, 2005, every licensee must take a four-hour ethics course on the Board's Rules of Professional Conduct every two years. This course is designed to meet that requirement.

In this course, we will define ethics and provide you with reasons you should be encouraged to continue educating yourself with the goal of achieving the highest standards of ethical conduct as a CPA.

The course will then discuss ethical reasoning and its application to common dilemmas that you may experience.

Next, we will review the core values of the CPA profession (integrity, objectivity and independence).

The final chapter of this course will discuss the Texas Board's Rules of Professional Conduct as they apply to all aspects of professional accounting work whether performed by CPAs in client practice, in industry, in education or in government. This chapter will also illustrate enforcement procedures which the TSBPA has taken to apply the Rules.

Throughout this course, you will be provided with case studies that demonstrate the application of ethical principles, values, ethical reasoning and the Rules of Professional Conduct.

Ethical Principles and Values

While many of the prior Texas ethics courses you may have taken merely required you to memorize the Texas Rules of Professional Conduct for CPAs, this course will attempt to encourage you to become educated in ethical principles and values as well as ethical reasoning as it applies to common situations that you may experience in your profession.

To begin, it may interest you to understand more about the definition of ethics, ethical principles and values and the history of the Texas Rules of Professional Conduct.

Defining Ethics

Ethics (also known as moral philosophy) can be defined as "a branch of philosophy that addresses questions about morality — that is, concepts such as good and evil, right and wrong, virtue and vice, justice, etc."

Of the various sub-branches of ethical study, the following are the major sub-branches:

- "Meta-ethics, about the theoretical meaning and reference of moral propositions and how their truth-values (if any) may be determined;
- Normative ethics, about the practical means of determining a moral course of action;
- Applied ethics, about how moral outcomes can be achieved in specific situations;
- Moral psychology, about how moral capacity or moral agency develops and what its nature is; and
- Descriptive ethics, about what moral values people actually abide by."

Ethics on the other hand, can also be defined as "the science of human duty; the body of rules of duty drawn from this science; a particular system of principles and rules concerning duty, whether true or false; rules of practice in respect to a single class of human actions; as, political or social ethics; medical ethics."

While the first definition offers a look at ethics as a philosophy, the above definition refers to ethics more as a set of rules and principles.

The term ethics can be defined in many ways. In the context of this course, we will use the term "ethics" to mean a set of rules based on an individual's or specific group's principles and values.

Ethical Principles and Values

Our ethical principles and values are the guides to our ethical decision making, as they provide the direction in which to reason the decision we will make regarding a particular dilemma. For example, if a person truly values people and believes in the principle that all people should be treated equally, they would most likely not be compelled to make any decisions based on racism.

The following are some examples of ethical principles:

- **Autonomy –** Each person should be allowed to make their own decisions based on their lives.
- **Beneficence –** The duty to do good both individually and for all. This principle is mainly associated with the utilitarian ethical theory which we will discuss later in this course.

- **Confidentiality –** The duty to respect privacy of information and action.
- **Finality –** The duty to take action that may override the demands of law, religion, and social customs.
- **Justice –** All people should be treated fairly.
- **Least harm –** A person should base their decisions on doing the least amount of harm to the fewest number of people.
- **No Harm –** Unlike the principle of least harm, this principle requires the duty to cause no harm, both individually and for all.
- **Publicity –** The duty to take actions based on ethical standards that must be known and recognized by all who are involved.
- **Respect for persons –** A person should honor others, their rights, and their responsibilities as we honor ourselves. In addition, people should not be used as a means to our end.
- **Understanding/Tolerance –** A person should appreciate and accept other people's viewpoints, if reason dictates doing so is warranted.
- **Veracity –** A person should always be honest and tell the truth.

While all individuals are encouraged to create their own principles and value system, it should also be recognized that when joining a specific group or profession, you are generally required to also accept the principles and values that as a whole they have agreed upon. For example, when becoming a CPA in the state of Texas each applicant is required to take an oath of office to support the laws and Constitution of the United States and of Texas and the rules adopted by the Texas State Board of Public Accountancy.

There are basically two philosophies used to resolve ethical dilemmas, related to CPAs, which are utilitarianism and rule deontology.

Utilitarianism (teleological ethics)	The promotion that the best long-term interest of everyone concerned should be the moral standard: one should take those actions that lead to the greatest balance of good versus bad consequences

Deontology (Kantian ethics)	It deals with the concept of duty and the rightness of acts. It emphasizes maxims, duties, rules, and principles that are so important that they should be followed whatever the consequences.

The Purpose of Ethical Education for CPAs

The first professional accountants were known to have originated in England during the late 1800's. However the title of Certified Public Accountant (CPA) was first created when the state of New York, in the year 1896, through the work of its states legislature, passed a law designating the professional status. By doing so, New York also set the path for the process of regulating the accounting profession at the state level rather than the federal level.[1]

Today, all jurisdictions in America have passed accountancy profession laws as well as laws governing all other professional titles within their states. In addition, all American state legislatures still regulate the majority of the administration of the CPA examination, licensing, maintenance and regulation of membership into the accountancy profession. Their regulation includes the specific requirements for continued professional education (CPE) for all CPAs within their jurisdiction.

Accounting ethics are believed by many to have first been introduced by Luca Pacioli (the "Father of Accounting") and later expanded by government groups, professional organizations, and independent companies. Michael J. Fischer, in his paper "Luca Pacioli on Business Profits," concludes that "it appears almost certain that he [Pacioli] would not tell us that there was anything fundamentally wrong or undesirable about engaging in business activities nor the pursuit of profits. In fact, Pacioli indicated his belief that the profit motive is a critical element of the successful business. However, it appears just as clear that Pacioli would strongly advise us to conduct our business both honestly and, perhaps more importantly, with a constant eye toward appropriate conduct of business people – individuals. Further, Pacioli clearly did not suggest that businesspersons should somehow separate their business

[1] "A Reasoned Approach to Reform – White Paper," AICPA, Section II.1, January 2003

from their personal lives. Quite the contrary, he indicated that successful businesspersons should see the secular and spiritual aspects of their lives as inextricably intertwined, and further that in the conduct of their business affairs they should "above all keep God before [their] eyes" (Geijsbeek, 1914, pp. 37–38; Brown and Johnston, 1963, p. 34; Cripps, 1995, p. 9)"

While the majority of the CPE which Texas CPAs are required to report each year is technical in nature, the TSBPA does now require that all Texas CPAs also receive training in ethics. Though producing accurate and timely financial statements is the primary purpose of accounting, many people consider ethics for CPAs to be just as important.

Nine Good Reasons to be Ethical (from ETHIX)[2]

1. Litigation/Indictment Avoidance
2. Regulatory Freedom
3. Public Acceptance
4. Investor Confidence
5. Supplier/Partner Trust
6. Customer Loyalty
7. Employee Performance
8. Personal Pride
9. It's Right

Subsequent to the collapse of Enron and Andersen LLP, the Texas State Board of Public Accountancy (TSBPA) decided that two hours of board-approved ethics continuing professional education (CPE) each three years was not enough. Beginning January 1, 2005, every licensee must take a four-hour ethics course on the Board's Rules of Professional Conduct every two years.

Texas is not the only state which requires ethics training for CPAs. Many other states have followed Texas' lead and developed requirements of their own.

While most, if not all, CPAs agree that a CPA should achieve and maintain the highest standards of ethical conduct, there has been much controversy as to the effectiveness of ethics courses in accomplishing this goal.

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[2] ETHIX, Bulletin (1), http://www.allbusiness.com/accounting/214505-1.html

Can you actually teach someone to starve before they would steal food? Most believe that although education like the threat of punishment cannot completely eliminate unethical acts such as theft, it can greatly reduce the probability of it occurring.

The technical training we receive as CPAs does not eliminate the possibility that we will err in the way we choose to account for a particular transaction, however; it significantly reduces the probability. Likewise, ethics training that we receive will not eliminate the possibility that we will not exercise good judgment in a particular situation, but it will greatly reduce the probability.

♦ Case Study ♦

In 1993, Mary Beth Armstrong completed a study (Mary Beth Armstrong, "Ethics and Professionalism in Accounting Education: A Sample Course," Journal of Accounting Education, 1993), in which she provided data demonstrating that an accounting ethics course can increase a participant's ethical sensitivity.

Armstrong tested all students at the beginning and the end of the semester, using Rest's Defining Issues Test. Her data indicated that those students who had already taken a general ethics course and who also took the ethics and professionalism course scored significantly higher on Rest's Defining Issues Test. An increase in one's ethical sensitivity is thus the result of a synergy of academic experiences in ethics, she concluded.

Rest's Defining Issues Test (DIT), developed by James Rest in 1979, is designed to assess a person's stage of moral development. The stages used are based on Kohlberg's approach to morality, which places individuals into one of the following six stages of moral development:

- Stage 1: The morality of obedience: Do what you're told.
- Stage 2: The morality of instrumental egoism and simple exchange: Let's make a deal.
- Stage 3: The morality of interpersonal concordance: Be considerate, nice, and kind: you'll make friends.
- Stage 4: The morality of law and duty to the social order: Everyone in society is obligated to and protected by the law.
- Stage 5: The morality of consensus-building procedures: You are obligated by the arrangements that are agreed to by due process procedures.

- Stage 6: The morality of non-arbitrary social cooperation: Morality is defined by how rational and impartial people would ideally organize cooperation.(Rest, & Narvaez, 1994, p. 5)

Seven Goals of Accounting Ethics Education

- Relate accounting education to moral issues.
- Recognize issues in accounting that have ethical implications.
- Develop "a sense of moral obligation" or responsibility.
- Develop the abilities needed to deal with ethical conflicts or dilemmas.
- Learn to deal with the uncertainties of the accounting profession.
- "Set the stage for" a change in ethical behavior.
- Appreciate and understand the history and composition of all aspects of accounting ethics and their relationship to the general field of ethics. —Stephen E. Loeb[3]

[3]Stephen E. Loeb, 1988, "Teaching Students Accounting Ethics: Some Crucial Issues"

Chapter 2
Ethical Reasoning and Dilemmas

Largely due to the recent corporate scandals at Enron, WorldCom, Arthur Anderson, etc. involving senior management and CFOs manipulating the books to make their companies appear more profitable, more and more research has been done to investigate the ethical reasoning and dilemmas that CPAs are faced with on a regular basis. The largest part of the prior research projects which have been done on ethical issues in accounting have generally avoided theoretical discussions about "right and wrong" or "good and bad" choices. Instead they have focused on determining whether or not accountants are abiding by the rules of professional conduct.

It is believed that the intense pressure put on the CPAs at the organizations which have collapsed recently, had a huge impact on them and ultimately led them to compromise their ethics. While we all understand that CPAs should not allow these pressures to interfere with their ethical, legal, and moral standards; sometimes this is easier said than done when face-to-face with an actual dilemma of our own.

The Reasoning Process

When resolving ethical dilemmas, Iris Stuart recommends an ethics model consisting of the following four steps:

1. The accountant must recognize that an ethical dilemma is occurring.
2. The accountant must identify the parties that would be interested in the outcome of the dilemma.
3. The accountant must determine alternatives and evaluate the effect of each alternative on the interested parties.
4. The accountant must select the best alternative.[4]

Case Study

A study was published in 1994, to determine how 100 randomly selected accountants, specifically auditors, used ethical reasoning when confronted with issues related to client confidentiality, Rule

[4] Iris Stuart, 2004, Ethics in the Post-Enron Age. SouthWestern/Thomson.p. 6. ISBN 0324191936

301, *Confidential Client Information*, of the AICPA' Code of Professional Conduct[5].

In this exercise you are asked to review the scenarios they were provided and respond to each circumstance described using the following guide (as originally provided in the study):

- To inform or not inform a third party of confidential client information,
- Indicate which response given in 1) is considered "good ethical behavior" if the Code was disregarded, and
- Justify your answers.

♦ Scenario 1 ♦

James Corporation employs the regional CPA firm of Green and Cash to audit its financial statements. The firm has been asked to prepare quarterly financial statements for the first quarter of 1986. Bob Ethics, a staff accountant, was assigned to do the work. During the course of preparing the statements, Bob discovered that James Corporation materially understated net income on last year's tax return. Bob informed his supervisor about this and the client is asked to prepare an amended tax return. The client, however, refused to take corrective action.

What would you do? Why?

After tallying the results for scenario 1, the study concluded that "given a Code, most (78%) respondents would not inform the IRS. This is in agreement with the rule of conduct. Although the variability increased, most CPAs (70%) in this situation, would make the same decision without a Code. This is consistent with the justification given that most CPAs perceived themselves to be an advocate of the client in a tax engagement. There was no perceived conflict in the rule of conduct and what most accountants perceived as good ethical behavior."

[5] "Ethical reasoning in confidentiality decisions," by Barbara L. Adams, Fannie L. Malone, and Woodrow James, Jr., The CPA Journal, July 1994

♦ Scenario 2 ♦

Johnson Manufacturing Corporation is a publicly owned company that manufactures equipment used by hospitals and medical laboratories. The company is audited by the national accounting firm of Adams & Pitre. One day, John, the senior in charge of the engagement overheard a conversation between two managers indicating that although they met inspection standards, they were aware of a defect in a particular piece of equipment, but they had not notified any of their customers because they felt the probability of malfunction was low. John takes this information to the controller and is told not to include it in the audit report. He then takes it to the manager on the engagement. The manager informs University Hospital, one of its clients, and also a major customer of Johnson Manufacturing Corporation, not to purchase any more equipment from Johnson. Johnson sues Adams & Pitre for violating the confidentiality rule.

What would you do? Why?

After tallying the responses to scenario 2, the study found that "most CPAs (78%) responding in this situation would adhere to the Code and not inform one client of information discovered while auditing another client. A large percentage (52%) of respondents, however, indicated that informing would be the "best ethical behavior." In most instances, "potential safety concerns" were cited as the justification for considering informing as the "best ethical behavior." Thus, there appears to be some conflict in adhering to the Code and the moral value of some CPAs."

♦ Scenario 3 ♦

William Johnson, a CPA, served as a director of Last National Bank for a year. As a director, William may be held liable for damages if he fails to use care and prudence in administering bank affairs and such action causes the bank to suffer a financial loss. In the course of an audit, William discovered a seriously weakened financial position in a client who has a large loan at Last National Bank. Disclosure of this condition to the other bank directors would minimize the bank's loss, however, since the audit has not been completed, this would represent a violation of Rule 301 of the Code.

What would you do? Why?

From the responses to scenario 3 that were received in the study, it was determined that "given a Code, a majority (78%) of CPAs would not inform, which is in agreement with the Code. A lesser percentage (53%), however, feel this is the best ethical behavior."

In conclusion, the study stated the following:

> *"The findings of this study indicate that CPAs usually adhere to the Code (rule deontology) in resolving issues involving confidentiality. However, such decisions are not always in accord with what they perceive as "good ethical behavior." The broad principles of the Code indicate that ethical conduct, in the truest sense, means more than abiding by a letter of a rule. It means accepting a responsibility to do what is honorable or doing that which promotes the greatest good to the greatest number of people, even if it results in some personal sacrifice. Somehow, the profession needs to emphasize the "greatest good" criterion more strongly in applying the rules of conduct."*

Greed

One of the most common reasons CPAs compromise their ethical values is due to greed. Greed, an excessive desire to possess wealth or goods, can be so overpowering that many times it so overwhelms us that we do things we know are wrong. Most that are driven by greed always seem to somehow find a way to justify their actions, in a way that convinces them that what they are doing is not really unethical.

The following case study is an abbreviated version of what happened to one corporate executive (who chooses to remain anonymous). In his own words, the once successful executive describes how he let greed interfere with his otherwise moralistic manner of doing business. It is his hopes that by sharing this story, he will be able to help others avoid the pitfalls that he encountered. Italicized below are the points that he specifically would like to emphasize.

Case Study

How It All Began

It had been six years into a very prosperous career in the financial services industry and one year into my tenure with a new company. Then it all began one winter night as I drove home from a long day at work. Back then, I was going through some minor financial hardship. I basically had an outstanding debt of approximately $6,000, which had been weighing heavily on my finances. The year before, my father passed away and I had to support my mother financially. In so doing, I racked up some debt to pay for her living expenses until things came back to normal. I also racked up some sense of frustration over my inability to be financially capable and mange to support my family with more ease. Of note, my salary then was already in the range of $60K a year, a figure that could've been enough to get me through my debts in due time, but for various reasons, I just couldn't manage on.

As part of my job, I was solely responsible for managing the relationship with several vendors and had discretion over handling invoices and payments to them. These expenses ran in the range of $50-$80K a year. Specifically there were two vendors, which as I will explain, both became components of my scheme, without their knowledge that is. Let's call them vendor A and vendor B. Vendor A was responsible for providing research tools and analysis. Vendor B provided all the technology support for vendor A, but I paid them both directly.

Towards the end of the year, vendor B, the technology provider, withdrew from the contract because I had objected to their dramatic raising of fees. Following their departure, and under pressure from me (with no malicious intentions), vendor A hired a technology consultant on a full time basis, who was tasked with providing the same services that the old vendor provided. This new arrangement translated into savings of tens of thousands of dollars, as the cost of hiring that consultant was much smaller than paying the old vendor for virtually the same services. Also worth mentioning, the departure of the old vendor and the delegation of their technology support services to the remaining vendor did not become known to my superiors. It just so happened that the new arrangement transpired very quickly.

So back to that one night when I was driving home from the office: In the weeks before, I had received notices regarding my outstanding debts and I was stressing about it. So sitting in traffic, listening to the radio, I had the first glimpse of an idea: Since I saved a lot of money with this new vendor arrangement, what if I could utilize some of those savings; kind of give myself a bonus, to help me get out of debt.

I thought to myself that this would be just an isolated act that did not represent who I was as a person. I justified to myself that tapping into those supposed savings of a few thousand dollars would hardly impact the company financially, given its colossal annual revenues of over a hundred million dollars. I told myself that it would only amount to rewarding myself for my successful negotiations, which had led to the drastic reduction in the cost of vendor services. Most notably, I convinced myself that this would be an exceptional one-time transaction, not a continuous scheme, and was by no means an act of fraud.

Lying To the Mirror

If there's one phase of fraud's psychological continuum you need to watch out for, this beginning phase is it! It's that point before you actually cross the line, but when you begin rationalizing why crossing the line is justified. For me that very moment was on that winter night when I rationalized to myself that stealing money from my employer was not theft but rather a business transaction. Sure enough, almost every embezzlement offense I've read about had traces of that same dynamic: the offender rationalizing that his action was justified, or that it didn't represent who they are or that it was something less deplorable than what it really was – fraud!

As you're reading this, and if you're encountering a similar situation, I recommend that you take an honest look at any wrong actions you've taken or are about to take. Most likely that corrupt choice was justified by a giddy rationale, which conveniently made your self-serving behavior seem acceptable. Believe me, once you cross that line, turning back just gets harder and harder. You have to remember that in my case and prior to that date, I had never done anything remotely close to this.
So if you're thinking to yourself, "the fraud I'm committing does not represent who I am. Really I'm not that kind of a person...," well you better think again. You know the old adage, "stupid is as stupid does"? Well the moment you commit a crime, you ARE a criminal, regardless of whether it's your first offense. Further, believing that you are a decent

person—and you may be indeed—does not give you impunity from doing indecent things. Who we are is more a reflection of what we do than who we believe we are.

Sure enough, I considered myself a decent person. I truly did. I based this self-assessment on my dignified views of people and of the world, which lacked rancor or envy. I based it on my lifelong encounters with family, friends and teachers, to whom I always showed respect and tenderness. I based it on the various points of my history where I often opted to do the right thing at the expense of giving up something in return.

But the moment I committed fraud is the moment I ceased to be a decent person. What I did is what mattered; not who I thought I was. Ask yourself this simple question: Is what I'm doing illegal? The answer should be a simple yes or no. No explanation of how decent you [otherwise] are should matter.

Fraud Triangle

I did not linger at the question. I slipped right through it with my faulty reasoning, fueled by a need for money. I worked out my plan as follows: I would establish a new corporation that bore a similar name to vendor B, who no longer provided us services but their departure was unknown to my superiors. Using fictitious invoices that looked exactly like the ones vendor B used to send us, I would create invoices for work that was no longer done by that vendor but that was being provided by the other vendor, who I legitimately paid separately. I would submit those invoices to Accounting and would request to pick up the checks personally under the excuse that I needed to overnight them myself to ensure proper delivery. I would then deposit the checks into a bank account that I would establish for that new shell company.

Once I paid off the debt, I would stop. Further, I vowed to myself that as soon as my financial situation improved, I would pay back the money by making a direct payment to the remaining vendor out of my pocket in the same amount that I tapped into.

Once again I point to the conniving nature of "rationalization," which is the cornerstone of all embezzlement offenses. Criminologists call it the Fraud Triangle: Existence of Pressure (financial need) and presence of Opportunity (money,) followed by Rationalization that the *wrong behavior is justified by valid reasons. For the weak of will, these factors combined could give birth to fraud, especially in the absence of a strong moral code. And in my case, they did.*

No Turning Back

So it was, I established a corporation that bore a similar name to vendor B. I then opened a bank account for that corporation. I turned in my first invoice for the amount of $8,500 using the template from the original vendor that was emailed to me. I requested that accounting provide me the check personally. I picked up the check and deposited it into the bank, where I had been a regular client, and the slight difference between the name on my account and the name to whom the check was payable went unnoticed. The first transaction went smoothly. I transferred the money from my business account to my personal account and paid off the debt in its entirety. I planned to close the business account the next day and dissolve the shell company.

A day later, I had not done that. I was very busy with work and just decided to put it off for another week or so. A week later I still had not done that. A month later I still had not done that. A couple of months later I needed money again and I repeated the process, albeit for a much smaller amount. After that, I just couldn't stop. Over the course of two years, I had generated over a dozen invoices and received an equal number of checks for what eventually amounted to nearly one hundred thousand dollars.

So how did I make the leap from a one-time transaction to an ongoing process? As pitiful as any explanation may sound, the merits of the additional income simply blinded me. The monetary reward made my initial flawed justification all the more believable: I wasn't committing fraud; I was just tapping into the savings that I managed to yield! The depths of my action (betraying my employer) and the possible repercussions (legal and professional) all languished in the background, overshadowed by the handsome financial rewards and suppressed by the seemingly acceptable rationalization (I wasn't hurting the company financially!)

Intentions Don't Count

Criminologists also describe another dynamic in the mindset of the embezzler, something called "wages in kind." This occurs when the embezzler believes he's entitled to the assets he's stealing. There's the famous tale about the bookkeeper who was denied a $100 monthly raise. Over the next 10 years, he embezzled a total of $12,000 in the form of $100 a month of fraudulent payments to himself, the same raise amount he had asked for!

In my case, I did not have any such entitlement claims. On the contrary, during the couple of years following the beginning of the scheme, my prominence in the company was rising exponentially. I had built a name for myself in the industry as a research analyst and generated a lot of publicity for the company through my various research papers. I won employee recognition awards, I was allowed to hire more staff and I basically had a very rewarding job in more ways than one. In all honesty, I truly was passionate about the company and my work, and was known around the company for my uplifting demeanor and my positive attitude. I sincerely cared about the success and future of the company.

Paradoxically enough, having this genuine heartfelt admiration for the organization made me all the less guilt-ridden about what I did behind their back. It somehow alleviated the awfulness of my actions. The incongruity of my rationale reminds me now of an episode of Sex and The City, where a female character walks in on her boyfriend having sex with another woman. The man caught red handed looks at her and says "This is just sex, but I love YOU!"

Equally delusional, I convinced myself at the time that cheating on the company was not necessarily deplorable, since I truly cared for them! But now that I look back at those years, I realize that I did hold some of those unfounded "wage in kind" views. To the extent that I believed I was making a lot of money for the company and truly cared for their well-being, I rationalized that diverting some additional income to myself was not entirely unconscionable. Oh how we fool ourselves!

As you're reading this, and if you're encountering a similar situation, once again I ask you to honestly examine the nature of your action. If you believe you're entitled to some additional privilege from your employer, that's understandable. But know this: when in the midst of fraud, one often looks for and finds easy ways to justify his actions. With me, it started with the rationale that I was capitalizing on some savings I had earned for the company. Then I rationalized that the company's financial state was so strong that my theft would not impact it. Then I believed that my genuine passion for the company neutralized *the fact that I stole from them. The point is that you'll never run out of frivolous reasons to justify your actions. What I advise you to do is to admit to yourself that no one reason justifies stealing from your employer (or anyone else for that matter.) If that's not enough to stop you, then think of the hefty price you'll pay in the end compared to the forgone privileges to which you believe you're entitled. For me, I'm going to prison very soon; a hefty price indeed!*

Above all, remember that your biggest enemy is yourself. Look at the outrageous excuses I used to justify my behavior (I made them money and so a little theft is okay!) I think I just wanted to believe any excuses, as senseless as they were, so that I could suppress the guilt I was feeling. And this was my biggest lie: I believed that I believed my lies! The truth is, in all of this, the person I deceived the most was not my employer; it was me.

So stop lying to yourself and face the truth. There is a reason [individuals] with substance abuse problems begin their therapy by first admitting that they ARE substance abusers. Acknowledging your wrongdoing is the first and most critical step to end the fraud. Without it, your lies will just get bigger and your chances of stopping will get smaller.

Fear subsided

Now you have to wonder though: guilt aside, do embezzlers fear getting caught? Did I? Would you?

For me, the answer is yes, I did, well at least in the beginning. But with time, this act seeped into my life and became simply an accepted fact of my existence. I was so blinded to reality by the hypnotizing effect of money that I completely discarded any attempts to confront the fearful repercussions of my actions. As idiotic as it may sound, I got to a point where I almost forgot about the scheme, I just did it! Do I sound fearless to you? Think again. It wasn't the lack of fear that blinded me; it was the greed, the money, and most of all, the denial. I avoided facing reality by digging my head in the sand pretending that if I didn't see the problem it would just cease to exist.

There's a famous fraud story about this CFO who had sole control over the accounting systems at a mid-size bank. One day he tapped into some funds in one account and managed to conceal it through making

fake reverse entries in another account. He did this for a few years completely undetected and amassed over $150,000 in illegal funds. Then one day, a customer made a double payment to the bank. The redundant check was forwarded to the CFO for processing. Get this, after sitting at his desk untouched for a week, the CFO finally took the check, endorsed it to himself and deposited it directly into his account! When the customer got the returned check and realized the foul play, he called the company and eventually an outside audit uncovered the entire scheme.
So why do you think the CFO went as far as to make such an incriminating move signing his own name on a client's check? Was he fearless?

Absolutely not! Like me, his greed grew over time to the point that he became incapable of reasoning. Hardly an excuse for his illegal actions, or mine for that matter, but the point I'm driving home is that after a while, you're bound to lose sight of reality. If you thought it was hard to control your actions in the initial stages, wait until you get farther along. Greed overpowers fear, especially when you grow accustomed to the financial rewards. So be wary, if you're already in the midst of committing fraud, it's NOT too late to stop. If you use the rationale of "I'm too far along in this mess to stop now," you're wrong. It will only get worse from here, both in legal terms and in the sense of your ability to stop. And if you think your lack of fear is a sign of your infallibility, you're wrong again. The absence of anxiety is rather a sign that you're so enmeshed in your foolish behavior that its severity doesn't faze you anymore. Sooner or later, your foolish behavior will catch up to you, as it did to me.

Reality Hits

Nearly two years into my scheme, someone in accounting noticed a discrepancy in two of the fictitious invoices I had submitted. In less than two days, a simple audit managed to uncover the entire scheme. One Monday morning in the office, I was confronted with the findings and I admitted my crime and provided full details about the nature of the scheme. I was fired on the spot and was told to expect legal action against me. Here's the horrifying part, and I'm being truthful when I tell you this: When they confronted me about the scheme, for a split second I couldn't tell if I had truly done this or if I had just once thought about doing it! I know it sounds silly, perhaps even pathetic. But this is another of greed's many tricks: it gives birth to other traits. In my case, one of those traits was none other than "denial." So it was that when I got into my car and drove home, I had only one thought in mind: Suicide. I couldn't face what I had done. I couldn't face what awaited me!

When denial is reversed, all you're left with is a big shock. And in my shock, I could think of no other way to avoid the shame awaiting me except by not being there to face it. Worse yet, I just couldn't stand myself; I resented every last breath of my existence. In a way, I really wanted to punish myself!

To spare you the morbid details, my suicide attempt was not successful. I slit my wrists multiple times and swallowed 90 pills of a sleeping aid, but ended up losing consciousness for 36 hours and losing little blood. When I woke up in a daze, not sure if I were dead or alive, I immediately called my fiancé and my brother, who came to my aid. I only lived because I missed the veins.

After recovering from that initial shock, I came to my senses and realized what had really happened. I retained the services of an attorney and attempted to reach a civil compromise where I'd pay back the money, which I had already spent over the course of two years.

The more I regained sight of reality, the more I realized how bleak that reality was. But I knew that despite whatever state of denial I was under in the past two years, my actions were real and I had to take responsibility for them. I waited, and two weeks later, I was arrested at my home.

The Aftermath

I'm now out on bail, awaiting my sentencing. I expect to begin my incarceration very soon. Due to the nature of my role, I have also been barred from the securities industry for life. Predictably, I'm liable for all the funds I embezzled and will be ordered to pay them in full (I already voluntarily began paying back some of the money with the help of my family.) In addition, the legal fees I've incurred in the process already amount to nearly what I stole. But this is nothing compared to the intangible damage I've caused. The news of the whole incident was made public and virtually everyone who had any association with my employer, my colleagues included, became fully aware of the whole ordeal. Shame and a tarnished reputation will haunt me forever. In committing my act, I have betrayed so many people who trusted me; a breach of trust of which I'm reminded every other day in my nightmares. I've disappointed those who believed in me, and gave them reasons not to ever believe again. Worse yet, I've disappointed my family, especially my mother, who despite the support she gave me during my crisis, her disappointed eyes can't help but tell the truth.

You know, some mistakes are reversible and some damage is reparable. But with tales of betrayal, much like the cheating boyfriend story I mentioned earlier, there is little you can do to alleviate the harm you caused to others and to yourself, especially the legal consequences. All that's left to do is to turn this saga into an experience that makes a better person out of you, not a worse one. But believe me, you're much better off not having to go through it in the first place.

The Right Choice

So in my final words to you, I'll say this: laws exist not just because someone imposed them upon us; they exist because they're right! They validate human concepts, which even without the existence of [those laws], are still sensible. Stealing money that doesn't belong to you is the wrong thing to do, even if law didn't prohibit it.

But there IS a law that prohibits it, and when you break that law, there are dreadful repercussions waiting for you. Those repercussions, including going to jail, are life-altering and their damage will haunt you for the rest of your life. The ramifications of your actions will not only affect you but will also hurt your family and loved ones. Greed and denial will make you lose sight of those consequences or even ignore them. Don't let them blind you. Instead, do the right thing: Stop the fraud now or just don't start it. You have the choice. Believe me, I'd do anything to go back in time and make that right choice. But I can't, so instead, I hope to help others do so.

I wish you the best of luck doing the right thing and staying out of trouble!

-- *Someone who's been there.*

Once I read the above story, I had some additional questions which the gentleman who wrote the above story kindly agreed to answer. The following are a few of the questions I asked:

Question: What, if anything, do you think could have been done by those around you which may have prevented you from embezzling the funds?

Answer: I think if someone were to bring to my attention a similar story like the one I'm now sharing with the public, it would have likely brought me to my senses and made me see what I was doing for what it REALLY was. One of the problems is that embezzlers often unconsciously alter their perception of reality in a way that effectively subsides their guilt and quells their fear. But a reality check in the form of hearing or reading about someone else's horrid tale is bound to bring them out of that self-induced hypnosis and make them stop. Further, I think it has an even higher chance of deterring then from embarking on the fraud in the first place.

Question: If you hadn't been caught, do you think you would have stopped by yourself?

Answer: Yes, I think I would have.

Question: Without implicating anyone else, did you tell anyone and if so, what was their reaction?

Answer: No, nor did I feel the urge to. I used to tell friends that I do some consulting on the side; and after a while I sort of believed I did!

Question: Did the idea of "getting away with it" excite you or was it all for the money?

Answer: I never thought about getting caught. My view of the whole situation conveniently ended at the part where money entered my bank account. But I can tell you for sure that I did not get any kicks out of doing it either. I loathed turning in the fake invoices and dreaded even more going to bank to deposit the checks. My research on the topic, however, tells me that some people do enjoy the "drill." I wasn't one of them.

Question: If you were to start your own company, what would be the most important types of controls that you would put into place to prevent someone from embezzling from you?

Answer: Besides, the obviously recommended ones (separate duties, monitor aberrant behavior, check backgrounds, audit regularly), I would definitely raise awareness amongst my employees of the topic

> of embezzlement. I think directing them to services like my campaign, as well as others, will help serve as some form of a deterrence, in the least because they'll know that the owner is not oblivious to the issue.

Success

Many times our unethical behavior may be driven by our need to succeed. But, how do you measure success? Whether it be "climbing the corporate ladder" or "adding another zero," to our salary, how much fame or fortune does a person really need to feel successful?

♦ Case Study ♦

On March 10, 2009, a Criminal Information Complaint was filed in Manhattan federal court charging Bernard L. Madoff with eleven felony charges including securities fraud, investment adviser fraud, mail fraud, wire fraud, three counts of money laundering, false statements, perjury, false filings with the United States Securities and Exchange Commission (SEC), and theft from an employee benefit plan. There was no plea agreement between the Government and the defendant. On March 12, 2009, Madoff pleaded guilty to all eleven counts in the Information. On June 29, 2009, Madoff was sentenced by Judge Chin to a term of imprisonment of 150 years.

David G. Friehling, the CPA who performed audit services for Madoff, pleaded guilty November 3, 2009 to nine criminal charges carrying a potential prison term of 114 years. Among the charges are securities fraud, investment advisor fraud, making false filings with the SEC and obstructing or impeding the administration of the Internal Revenue Office (IRS). At 49 years old, having a wife and three children, Friehling's career as a CPA is over.

According to court documents[6], from 1991 through 2009, Friehling worked as a sole proprietor at the firm Friehling and Horowitz, CPAs. Jerome Horowitz (Friehling's father-in-law) is reported to have retired in or around 1991, and Friehling was the only employee of the firm since that time.

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[6] U.S. Justice Department Guilty Plea Transcript, November 3, 2009, http://www.justice.gov/usao/nys/madoff/friehling20091103guiltypleatranscript.pdf, retrieved on October 26, 2010

Although he had no staff to assist him, for 17 years Friehling's firm was retained by Madoff Investment Securities to audit its financial statements that were filed with the SEC. Friehling also stated in court that prior to his retiring, his father-in-law, Jerome Horowitz, was the auditor for Madoff Investment Securities. Horowitz also occasionally assisted Friehling, according to his testimony, in conducting the audit for Madoff Investment Securities after he retired and until 1998.Horowitz passed away from cancer, on March 12th 2009, on the day Madoff pleaded guilty.

Although he received a monthly retainer throughout the 17 years, the courts found that Friehling never once actually performed a meaningful audit of Madoff Investment Securities (i.e., he did not verify any of the information provided to him by Madoff). Yet, over the 17 years, he issued numerous reports stating that he had done so and issued unqualified opinions regarding those financial statements.

In addition, the courts found that Friehling also had a conflict of interest and was therefore not independent of Madoff Investment Securities. Friehling and his family members all had investment advisory accounts at Madoff Investment Securities. Friehling's investments exceeded $500,000 according to his testimony. No disclosure of this fact was ever made in Friehling's reports.

Friehling also plead guilty to aiding and abetting a device, scheme or artifice to defraud. This charge resulted due to the evidence that the courts found which they believe proved that Friehling knew at the time he certified the financial statements that they were materially false, but nevertheless issued an opinion that they were fair and accurate.

As these statements were filed with the SEC and investors of Madoff Investment Securities relied upon these statements to make investment decisions, Friehling was also charged and plead guilty to securities fraud, investment advisor fraud and making false filings with the SEC.

Finally, Friehling pled guilty to impeding the administration of the IRS laws. From 1991 through 2008, Friehling assisted in the preparation of numerous false tax returns, with corrupt intent, for Madoff as well as others according to the courts.

While Friehling still maintains that he knew nothing of Madoff's engagement in a Ponzi scheme, in his testimony to the court he stated: "In what is surely the biggest mistake of my life I placed my trust in Bernard Madoff."

Do you think that the biggest mistake that Friehling made was putting his trust in Madoff? If not, what do you think was his biggest mistake?

Friehling is free on a 2.5 million bond and was originally scheduled to be sentenced on March 18, 2011.

A successful CPA, with a wife and three kids, compromised his core values of integrity, objectivity and independence for what he perhaps believed would make him even more successful. Will he now instead spend the rest of his life behind bars?

Chapter 3
Core Values of the CPA Profession

Integrity, objectivity and independence are the core values of the CPA profession. They are discussed in both the TSBPA Rules of Professional Conduct and the AICPA Code of Professional Conduct. When a CPA loses their commitment to these core values, they lose their honor.

"Honor is better than honors." - President Lincoln

♦ Case Study ♦

Founded in 1913 in Chicago, Illinois, Arthur Andersen was an organization that was committed to integrity, objectivity and independence. Its founder, Arthur Andersen, donated more than $5 million dollars to universities for awareness of ethical issues pertaining to business, prior to his death in 1947. Anderson considered ethics to be the backbone of the firm.

After his death, it appears those values were lost, and the greed of corporate officers and its partners led to the scandals associated with WorldCom, Waste Management, and Enron. Now, what was once recognized as one of the top accounting and auditing firms in the nation, Arthur Anderson is a firm that has lost its honor.

Integrity and Objectivity

The Texas Rules of Professional Conduct require integrity and that a person in the performance of professional accounting services or professional accounting work shall maintain integrity and objectivity, shall be free of conflicts of interest and shall not knowingly misrepresent facts nor subordinate his or her judgment to others. In tax practice, however, a person may resolve doubt in favor of his client as long as any tax position taken complies with applicable standards such as those set forth in Circular 230 issued by the Internal Revenue Service and AICPA Statements on Standards for Tax Services.

A conflict of interest may occur if a person performs a professional accounting service or professional accounting work for a client or employer and the person has a relationship with another person, entity, product, or service that could, in the person's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the person's objectivity. If the person believes that the professional accounting service or professional accounting work can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, then this rule shall not operate to prohibit the performance of the professional accounting service or professional accounting work because of a conflict of interest.

Certain professional engagements, such as audits, reviews, and other services, require independence. Independence impairments cannot be eliminated by disclosure and consent.

A person shall not concurrently engage in the practice of public accountancy and in any other business or occupation which impairs independence or objectivity in rendering professional accounting services or professional accounting work, or which is conducted so as to augment or benefit the accounting practice unless these rules are observed in the conduct thereof.

♦ TSBPA Enforcement Action ♦

May 2009

Investigation No: 09-03-07L
Respondent: Eric Duane Boyt
Hometown: Midland
License No.: 066929
Rules Violations: 501.12 (now 501.73), 501.41(9) [now 501.90(9)], 501.41(13) [now 501.90(12)] Act Violations:901.502(6) & 901.502(11)

Respondent entered into an Agreed Consent Order with the Board whereby Respondent involuntarily surrendered his certificate. In addition, Respondent must pay $10,000 in administrative penalties in nine installments, with the first installment of $2,000 due within thirty (30) days of the date the Board ratified the Agreed Consent Order and each subsequent installment of $1,000 due every 30 days thereafter.

In December 1999, Respondent was employed as an accountant by Enron Corp. As part of Respondent's duties, he determined the accounting consequences of pending transactions in which Enron was involved. One of those transactions was Enron's proposed sale of barges located off the coast of Nigeria to Merrill Lynch. Although Respondent learned that Enron had promised Merrill Lynch that Enron would buy back the barges if Merrill Lynch could not find a buyer within six months, a promise that would jeopardize the accounting and eliminate the gain, Respondent was involved in removing all references to that promise in order to obtain the approval of the transaction by Arthur Andersen. In addition, he signed off on the deal-approval sheet (DASH) for this transaction as required by the risk assessment division in Enron and was prepared to lie about the true nature of the transaction.

The AICPA Code of Professional Conduct (ET Section 54 Article III) states that: "To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity." Integrity is defined as:

> *"an element of character fundamental to professional recognition. It is the quality from which the public trust derives and the benchmark against which a member must ultimately test all decisions."*

The Code notes that while integrity requires a CPA to be honest (it cannot accommodate deceit or subordination of principle), it also requires the CPA to recognize the constraints of client confidentiality. In addition, service and the public trust should not be subordinated to personal gain an advantage.

While integrity can be measured in terms of what is right or wrong, objectivity is a state of mind. According to the Code, the principle of objectivity imposes the obligation to be:

- impartial,
- intellectually honest, and
- free of conflicts of interest.

Rule 102 of the Code states that:

> *"In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others."*

A CPA may be considered in violation of this Rule if he or she:

- Makes, or permits or directs another to make, materially false and misleading entries in an entity's financial statements or records.
- Fails to correct an entity's financial statements or records that are materially false and misleading when he or she has the authority to record an entry.
- Signs, or permits or directs another to sign, a document containing materially false and misleading information.

Conflicts of interest should be considered for example when:

- A member has been asked to perform litigation services for the plaintiff in connection with a lawsuit filed against a client of the member's firm.
- A member has provided tax or personal financial planning (PFP) services for a married couple who are undergoing a divorce, and the member has been asked to provide the services for both parties during the divorce proceedings.
- In connection with a PFP engagement, a member plans to suggest that the client invest in a business in which he or she has a financial interest.
- A member provides tax or PFP services for several members of a family who may have opposing interests.
- A member has a significant financial interest, is a member of management, or is in a position of influence in a company that is a major competitor of a client for which the member performs management consulting services.
- A member serves on a city's board of tax appeals, which considers matters involving several of the member's tax clients.
- A member has been approached to provide services in connection with the purchase of real estate from a client of the member's firm.
- A member refers a PFP or tax client to an insurance broker or other service provider, which refers clients to the member under an exclusive arrangement to do so.
- A member recommends or refers a client to a service bureau in which the member or partner(s) in the member's firm hold material financial interest(s).- [Rule 102-2]

♦ Case Study ♦

Working for a company with an outstanding credit line and covenants that are required to be met in order for the line not to become due and payable in full, can always be a challenge for a controller. As the person in charge of reporting the financials, Sue Smith found herself in uncomfortable situations various times with this issue particularly with one company. Our biggest problem was our accounts receivable balance, Sue explains.

In the industry of providing training workshops, our contracts specifically stated the dates of the workshops and that in the event the workshop was cancelled by the client, the full amount of the contract would be due in full (a no cancellation policy).

The problem was that many of the contracts stating this policy were not being signed by the client. Although there were verbal agreements that this was the cancellation policy, without a written agreement, Sue did not feel it was appropriate to accrue the revenue on the financials. However, if she did not, it could mean that the line of credit would become due and payable as the company depended on the accounts receivable balance to meet their current ratio covenant. The owners may even fire Sue if that happened. She felt she would let her company and all of its employees down if she did not do her best to meet the covenant requirements. Or would she? It wasn't her responsibility to make sure the contracts got signed by the clients? Her responsibility was to report accurate and timely financial information. Sue finally decided that she could not report on a contract that was not signed.

What would you do?

Sue refused to accrue the revenue on contracts that were not signed. Yes, there were some complaints in the beginning, but thanks to the fax machine and a few fast moving sales representatives and clients, they were always able to get a signed copy when they needed it. Sue also noticed that fewer and fewer unsigned contracts existed and the board of directors seemed to have much more faith in her ability to control the financial processes.

Independence

Upholding integrity and objectivity values calls for avoiding both actual and apparent conflicts of interest. This is also referred to as being independent both in fact and in appearance.

> **Independence of mind.** The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.
>
> **Independence in appearance.** The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised. [ET Section 100.01]

The Texas Rules of Professional Conduct require that all CPAs, whether they are members of the AICPA or not, conform in fact and in appearance to the independence standards established by the AICPA and the Board, and, where applicable, the U.S. Securities and Exchange Commission, the General Accounting Office and other regulatory or professional standard setting bodies.

"Covered members" are required to comply with the independence rules under the AICPA Code of Professional Conduct. Covered members include:

1. An individual on the client's attest engagement team
2. An individual in a position to influence the client's attest engagement
3. A partner or manager who provides more than 10 hours of nonattest services to the attest client
4. A partner in the office in which the lead attest engagement partner primarily practices in connection with the client's attest engagement
5. The firm, including the firm's employee benefit plans
6. An entity whose operating, financial, or accounting policies can be controlled by any of the individuals or entities described in

items 1-5 or by two or more such individuals or entities if they act together

Exception: The Code prohibits these relationships if you are a partner or professional employee in a public accounting firm, <u>even if you are not a covered member</u>:

- Director, officer, or employee (or in any capacity equivalent to a member of management) of the client, promoter, underwriter, voting trustee, or trustee of any of the client's employee benefit plans
- Owner of more than 5 percent of an attest client's outstanding equity securities (or other ownership interests)

ET Section 100, Independence, of the AICPA Code of professional Conduct requires the following in respect to a CPA's independence when performing an attest engagement:

- A member should consult the rules of his or her state board of accountancy, his or her state CPA society:
  - If the members report will be filed with the U.S. Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB) and the SEC rules should also be reviewed.
  - If the member's report will be filed with the U.S. Department of Labor (DOL), the DOL rules should be reviewed.
  - If law, regulation, agreement, policy or contract requires the member's report to be filed under the Government Accountability Office (GAO) regulations, the GAO rules should be reviewed.
  - Any other organization that issues or enforces standards of independence that would apply to the member's engagement should also be reviewed. Such organizations may have independence requirements or rulings that differ from (e.g., may be more restrictive than) those of the AICPA.

Also understanding that it is impossible to address all potential independence conflicts which may occur, the AICPA requires that accountants use the risk-based approach to address matters which are not specifically discussed in the Code.

Risk-Based Approach to Independence

Applying the risk-based approach when determining independence generally means that when threats to independence are not at an acceptable level, safeguards must be applied to eliminate the threats or reduce them to an acceptable level. In cases when threats to independence are not at an acceptable level, and thereby require the application of safeguards, the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level must be documented.

ET Section 100-1, *Conceptual Framework for AICPA Independence Standards*, details the requirements of the risk-based approach to analyzing independence matters, as summarized below.

Steps Required Under the Risk-Based Approach to Independence

1. **Identify and evaluate threats to independence –** Identify and evaluate threats, both individually and in the aggregate, because threats can have a cumulative effect on a member's independence. Where threats are identified but, due to the types of threats and their potential effects, such threats are considered to be at an acceptable level (that is, it is not reasonable to expect that the threats would compromise professional judgment), the consideration of safeguards is not required. If identified threats are not considered to be at an acceptable level, safeguards should be considered.

2. **Determining whether safeguards already eliminate or sufficiently mitigate identified threats and whether threats that have not yet been mitigated can be eliminated or sufficiently mitigated by safeguards –** Different safeguards can mitigate or eliminate different types of threats, and one safeguard can mitigate or eliminate several types of threats simultaneously. When threats are sufficiently mitigated by safeguards, the threats' potential to compromise professional judgment is reduced to an acceptable level. A threat has been sufficiently mitigated by safeguards if, after application of the safeguards, it is not reasonable to expect that the threat would compromise professional judgment.

> Note: In cases where threats to independence are not at an acceptable level, thereby requiring the application of safeguards, the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level should be documented as required under "Other Considerations" of Interpretation 101-1, Interpretation of Rule 101 [ET section 101.02].

3. **If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered impaired.**

Definitions

Impair – For purposes of this framework, impair means to effectively extinguish (independence). When a member's independence is impaired, the member is not independent.

Threats – Threats to independence are circumstances that could impair independence. Whether independence is impaired depends on the nature of the threat, whether it would be reasonable to expect that the threat would compromise the member's professional judgment and, if so, the specific safeguards applied to reduce or eliminate the threat, and the effectiveness of those safeguards.

Safeguards – Controls that mitigate or eliminate threats to independence. Safeguards range from partial to complete prohibitions of the threatening circumstance to procedures that counteract the potential influence of a threat. The nature and extent of the safeguards to be applied depend on many factors, including the size of the firm and whether the client is a public interest entity. To be effective, safeguards should eliminate the threat or reduce to an acceptable level the threat's potential to impair independence.

Categories of Threats

(1) **Self-review –** Members reviewing as part of an attest engagement evidence that results from their own, or their firm's, nonattest work such as preparing source documents used to generate the client's financial statements

(2) **Advocacy –** Actions promoting an attest client's interests or position.
   i. Promoting the client's securities as part of an initial public offering
   ii. Representing a client in U.S. tax court

(3) **Adverse interest –** Actions or interests between the member and the client that are in opposition, such as, commencing, or the expressed intention to commence, litigation by either the client or the member against the other.

(4) **Familiarity –** Members having a close or longstanding relationship with an attest client or knowing individuals or entities (including by reputation) who performed nonattest services for the client.
   i. A member of the attest engagement team whose spouse is in a key position at the client, such as the client's chief executive officer
   ii. A partner of the firm who has provided the client with attest services for a prolonged period
   iii. A member who performs insufficient audit procedures when reviewing the results of a nonattest service because the service was performed by the member's firm
   iv. A member of the firm having recently been a director or officer of the client
   v. A member of the attest engagement team whose close friend is in a key position at the client

(5) **Undue influence –** Attempts by an attest client's management or other interested parties to coerce the member or exercise excessive influence over the member.
   i. A threat to replace the member or the member's firm over a disagreement with client management on the application of an accounting principle
   ii. Pressure from the client to reduce necessary audit procedures for the purpose of reducing audit fees
   iii. A gift from the client to the member that is other than clearly insignificant to the member

(6) **Financial self-interest** – Potential benefit to a member from a financial interest in, or from some other financial relationship with, an attest client.
   i. Having a direct financial interest or material indirect financial interest in the client
   ii. Having a loan from the client, from an officer or director of the client, or from an individual who owns 10 percent or more of the client's outstanding equity securities
   iii. Excessive reliance on revenue from a single attest client
   iv. Having a material joint venture or other material joint business arrangement with the client

(7) **Management participation** – Taking on the role of client management or otherwise performing management functions on behalf of an attest client.
   i. Serving as an officer or director of the client
   ii. Establishing and maintaining internal controls for the client
   iii. Hiring, supervising, or terminating the client's employees

Categories of Safeguards

(1) **Safeguards created by the profession, legislation, or regulation** – Examples include but are not limited to education and training requirements on independence and ethics rules for new professionals, professional standards and monitoring and disciplinary processes, external review of a firm's quality control system, legislation governing the independence requirements of the firm, and competency and experience requirements for professional licensure.

(2) **Safeguards implemented by the attest client** – Examples include but are not limited to safeguards such as the attest client has personnel with suitable skill, knowledge, and/or experience who make managerial decisions with respect to the delivery of nonattest services by the member to the attest client or a tone at the top that emphasizes the attest client's commitment to fair financial reporting.

(3) **Safeguards implemented by the firm, including policies and procedures to implement professional and regulatory requirements** – Examples include but are not limited to safeguards such as firm leadership that stresses the importance of independence

and the expectation that members of attest engagement teams will act in the public interest or policies and procedures that are designed to implement and monitor quality control in attest engagements.

Understanding the ever changing and complex environment that CPAs who perform attest services are practicing in today, the AICPA has published a checklist to simplify compliance with both the AICPA and GAO rules. The checklist, *Independence Compliance: Checklists and Tools for Complying With AICPA and GAO Independence Requirements, Second Edition,* can be purchased online at www.cpa2biz.com.

♦ Case Study ♦

Performance of Nonattest Services (Interpretation 101-3)

The following is a case study reported in the Journal of Accountancy (December, 2007) illustrating independence issues when performing nonattest services:

Construct Inc. is a small, family-owned-and-managed construction company that provides services to residential and commercial customers. The company employs George, an accountant who maintains the books and records, is familiar with GAAP and can prepare the financial statements. Because of a shortage of internal resources to do the work, Construct engaged its practitioner to help process the company's payroll. George oversaw the services in which the practitioner:

Used approved timecards and other client records to calculate the payroll and generate unsigned checks for the client's signature.

Transmitted payroll data to the client's financial institution (pre-authorized by the client).

Submitted electronic payroll tax payments in accordance with U.S. Treasury Department and other relevant jurisdictions' guidelines under arrangements made with the client and its financial institution.

In accordance with Interpretation 101-3, George assumed all management responsibilities for the practitioner's services. He also performed control activities related to payroll. These duties included spot-checking the payroll for accuracy by recalculating the payroll for select employees and comparing his amounts to those the practitioner calculated, reviewing disbursements to gauge consistency with prior periods and investigating any inconsistencies. The practitioner considered George capable of overseeing the payroll work for independence purposes.

However, during the audit, the practitioner identified a significant deficiency in internal control over financial reporting. He learned that George misclassified payroll expense between contracts when posting the job cost ledger. This would have caused a misstatement in the financial statements.

Does the practitioner's identification of a significant deficiency or material weakness in internal control over financial reporting in an area in which he or she previously performed nonattest services impair independence?

The test for independence when the practitioner performs nonattest services is whether he or she complied with Interpretation 101-3. Under that rule, Construct Inc. and the practitioner agreed to the responsibilities that each would undertake in connection with the payroll services engagement. This ensured that the practitioner would not assume management's responsibilities for the payroll process. Therefore, the fact that the practitioner concluded during the audit that a significant deficiency (or even a material weakness) in ICFR existed does not mean that independence was impaired when the payroll services were performed.

Chapter 4
Texas Rules of Professional Conduct

History of the Texas Rules of Professional Conduct

Before we begin discussing the Texas Rules of professional Conduct and select enforcement actions taken by the Board, it may interest you to understand the history of why and how the rules were established. In its February 2010 edition (VOL. 102) report, the Texas State Board reported that the enforcement procedures and policies of the Texas State Board of Public Accountancy (TSBPA) have evolved over the past 95 years.

The Rules of Professional Conduct were promulgated under the Public Accountancy Act, which directs the Texas State Board of Public Accountancy to promulgate rules of professional conduct "in order to establish and maintain high standards of competence and integrity in the practice of public accountancy and to insure that the conduct and competitive practices of licensees serve the purposes of the Act and the best interest of the public."

It all began in the year 1915, when The Public Accountancy Act established a Board of five members to examine and certify accountants within the State of Texas. While the Board did investigate and attempt to maintain the professionalism of accountants in Texas, it was not until 30 years later that it was actually given any authority to establish and enforce any rules of professional conduct.

In 1929, the Texas Society of CPA's established the first code of ethics for certified public accountants. While expectations of professional conduct were outlined in this code, enforcement actions for infractions of the code would merely mean that you would not be allowed to be a member of the Society.

However, in 1945 The Public Accountancy Act was significantly revised to meet the demands of the public for increasing education, experience requirements and professionalism within the field of accounting. The Board would now have the ability to create and enforce rules of professional conduct, as well as establish specific education and experience requirements for those licensed by the Board.

On September 1, 1946, the Rules of Professional Conduct went into effect. Through the process of establishing the rules, the Board required that all existing license holders vote on the rules.

Again revised in 1961, the Public Accountancy Act provided the Board with subpoena powers and streamlined the requirements for enforcement procedures.

The Board soon realized that it may be considered inappropriate for it to both investigate complaints against CPAs as well as to make judgments on those cases. For this reason, the Board created committees whose job it is to review the cases, hear arguments for the enforcement action and finally make recommendations to the Board regarding what action if any should be taken.

Currently there are three committees which hear complaints. Technical Standards Review (TSR) I and II committees are assigned to hear cases alleging violations of technical standards, while the Behavioral Enforcement Committee (BEC) hears all cases alleging misconduct which is not related to attest services. The members of each committee are appointed by the presiding officer of the TSBPA.

The Rules of Professional Conduct are intended to have application to all kinds of professional services performed in the practice of public accountancy, including services relating to:

- accounting, auditing and other assurance services,
- taxation,
- financial advisory services,
- litigation support,
- internal auditing,
- forensic accounting, and
- management advice and consultation.

Applying the Rules of Professional Conduct

The public interest should be placed ahead of self-interest, even if it means a loss of a job or client for a CPA.

The TSBPA regulates the accounting profession in an effort to provide competent, objective accountants and auditors for Texas' financial markets, banking systems, and businesses. The Board's major functions include:

- Administering the Uniform Certified Public Accountant (CPA) Examination;
- Certifying and licensing accountants who have passed the Exam and met all requirements;
- Registering firms engaged in the practice of public accountancy; and

- Enforcing provisions of the Public Accountancy Act, and taking disciplinary action when necessary.

The TSBPA's efforts include ensuring that appropriate action is taken and that due process is carried out in all enforcement cases. The staff annually investigates and prosecutes approximately 300 alleged violations of the rules of professional conduct and the statute.

The TSBPA's disciplinary process begins with a complaint, filed either by a member of the public, another government entity, or on the Board's own initiative. A staff investigation follows, sometimes with the assistance of an outside technical consultant.

The TSBPA designates certain investigations as "major cases." These involve CPA firms implicated in the audits of failed or troubled savings and loan organizations, financial institutions, insurance companies, and other cases of a major nature. Such cases are more complex and require substantial resources for pre-hearing preparations and prosecution. The Board engages the Texas Attorney General's office to assist in the prosecutorial process.

The remainder of this course will review the Rules of Professional Conduct (Rules), as summarized by the author of this course, and some of the enforcements actions taken by the Board.

Professional Standards

The Rules of Professional Conduct (Rules) require the following Professional Standards:

- A CPA should not permit his name to be associated with financial statements in such a manner as to imply that he is acting as an auditor with respect to such financial statements, unless he has complied with applicable generally accepted auditing standards.
- A CPA should not issue a report asserting that financial statements are presented in conformity with generally accepted accounting principles if such financial statements contain any departure from such accounting principles which has a material effect on the financial statements taken as a whole, unless the certificate or registration holder can demonstrate that by reason of unusual circumstances the financial statements would otherwise have been misleading. In such a case, the certificate or

registration holder's report must describe the departure, the approximate effects thereof, if practicable, and the reasons why compliance with the generally accepted accounting principles would result in a misleading statement.

- A CPA in the performance of consulting services, accounting and review services, any other attest service, or tax services shall conform to the professional standards applicable to such services.

♦ Case Study ♦

July 2010

Investigation No.: 10-02-07L
Respondent: Hector Homero Flores
Hometown: Duncanville
Certificate No.: 075204
Rules Violations: 501.60, 501.62
Act Violations: 901.502(6), 901.502(12)(B)

Respondent entered into an Agreed Consent Order with the Board whereby Respondent was reprimanded. Respondent must pay $6,750 in administrative penalties and $124.92 in administrative costs payable to the Board within 30 days of the date of the Board Order. In addition, Respondent is placed on Limited Scope and prohibited from performing attest services.

Respondent performed a compliance attestation engagement of a vocational school for the period from July 1, 2004, to June 30, 2005. The engagement was not performed in accordance with generally accepted auditing standards, *Statements on Standards for Attestation Engagements*, issued by the American Institute of Certified Public Accountants, and generally accepted government auditing standards. Respondent had to re-perform the engagement.

Responsibilities to Clients

In addition to the above Professional Standards, the Rules also require that all CPAs, whether they are members of the AICPA or not, conform in fact and in appearance to the independence standards established by the AICPA and the board, and, where applicable, the U.S. Securities and

Exchange Commission, the General Accounting Office and other regulatory or professional standard setting bodies.

Included in the section Responsibilities to Clients of the Rules are also the requirements for commissions and contingency fees. In general, a CPA or CPA firm may not receive a commission or contingency fee, when the licensee or the licensee's firm also performs services for that client requiring independence. There are also disclosure requirements if a commission or contingency fee is accepted.

♦ Board Ruling ♦

The Board has ruled that a consulting accounting expert may become a testifying accounting expert when the client for whom he is working makes his work available to a testifying expert. A consulting accounting expert who is working on a contingent fee basis should work closely with his client to insure that he does not inadvertently become a testifying expert through the actions of his client. An accounting expert may not accept a contingent fee for part of an engagement and a set fee for part of the same engagement. A consulting accounting expert who becomes a testifying expert may not accept a contingent fee for the part of his work done as a consultant, but must be compensated on a set fee basis for all of the work performed on the same engagement. A consulting accounting expert who enters into a contingent fee engagement should reach an agreement, preferably in writing, with the client as to how he will be compensated should he become a testifying expert prior to beginning the engagement.

Integrity and Objectivity

A person in the performance of professional accounting services or professional accounting work shall maintain integrity and objectivity, shall be free of conflicts of interest and shall not knowingly misrepresent facts nor subordinate his or her judgment to others. In tax practice, however, a person may resolve doubt in favor of his client as long as any tax position taken complies with applicable standards such as those set forth in Circular 230 issued by the Internal Revenue Service and AICPA Statements on Standards for Tax Services.

A conflict of interest may occur if a person performs a professional accounting service or professional accounting work for a client or employer and the person has a relationship with another person, entity, product, or service that could, in the person's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the person's objectivity. If the person believes that the professional accounting service or professional accounting work can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, then this rule shall not operate to prohibit the performance of the professional accounting service or professional accounting work because of a conflict of interest.

Certain professional engagements, such as audits, reviews, and other services, require independence. Independence impairments cannot be eliminated by disclosure and consent.

A person shall not concurrently engage in the practice of public accountancy and in any other business or occupation which impairs independence or objectivity in rendering professional accounting services or professional accounting work, or which is conducted so as to augment or benefit the accounting practice unless these rules are observed in the conduct thereof.

♦ Case Study ♦

May 2009

Investigation No: 09-03-07L
Respondent: Eric Duane Boyt
Hometown: Midland
License No.: 066929
Rules Violations: 501.12 (now 501.73), 501.41(9) [now 501.90(9)], 501.41(13) [now 501.90(12)] Act Violations:901.502(6) & 901.502(11)

Respondent entered into an Agreed Consent Order with the Board whereby Respondent involuntarily surrendered his certificate. In addition, Respondent must pay $10,000 in administrative penalties in nine installments, with the first installment of $2,000 due within thirty (30) days of the date the Board ratified the Agreed Consent Order and each subsequent installment of $1,000 due every 30 days thereafter.

In December 1999, Respondent was employed as an accountant by Enron Corp. As part of Respondent's duties, he determined the accounting consequences of pending transactions in which Enron was involved. One of those transactions was Enron's proposed sale of barges located off the coast of Nigeria to Merrill Lynch. Although Respondent learned that Enron had promised Merrill Lynch that Enron would buy back the barges if Merrill Lynch could not find a buyer within six months, a promise that would jeopardize the accounting and eliminate the gain, Respondent was involved in removing all references to that promise in order to obtain the approval of the transaction by Arthur Andersen. In addition, he signed off on the deal-approval sheet (DASH) for this transaction as required by the risk assessment division in Enron and was prepared to lie about the true nature of the transaction.

Competence

The Rules require that a CPA not undertake any engagement for the performance of professional services which he cannot reasonably expect to complete with due professional competence. Competence to perform professional accounting services or professional accounting work involves both the technical qualifications of the person and the person's staff and the ability to supervise and evaluate the quality of the work being performed.

If a person is unable to gain sufficient competence to perform professional accounting services or professional accounting work, the person shall suggest to the client the engagement of someone competent to perform the needed professional accounting or professional accounting work service, either independently or as an associate.

In addition, a CPA must exercise due professional care in the performance of professional services. This includes adequately planning and supervising the performance of professional services, obtaining and maintaining appropriate documentation to afford a reasonable basis for conclusions and recommendations in relation to any professional services performed.

♦ Case Study ♦

March 2009

Investigation No.: 09-08-03L
Respondent: Robert Kenney
Hometown: Selma
Certificate No.: 081309
Rules Violations: 501.74, 501.81, 501.83 and 527.4
Act Violations: 901.502(6) and 901.502(11)

Respondent entered into an Agreed Consent Order (ACO) with the Board whereby Respondent's individual license was suspended for one year; however, this suspension was stayed and Respondent was placed on probation for one year. Respondent must pay an administrative penalty of $3,500 and $842.48 in administrative costs within 30 days of the date the Board ratified the order, and Respondent shall complete and submit proof of completion of four hours of live CPE in the area of ethics within 60 days of the date the Board ratified the order.

Respondent prepared a client's 2007 personal and corporate tax returns incorrectly. In addition, Respondent practiced public accountancy through an unregistered entity and with improper firm names. Respondent also failed to participate in a peer review program.

The Rules for confidentiality require that except by permission of the client or the authorized representatives of the client, a person or any partner, officer, shareholder, or employee of a person shall not voluntarily disclose information communicated to him by the client relating to, and in connection with, professional accounting services or professional accounting work rendered to the client by the person.. This does not apply to the disclosure of information required to be disclosed by the standards of the public accounting profession in reporting on the examination of financial statements or as prohibiting disclosures pursuant to a court order signed by a judge, a congressional or grand jury subpoena, investigations or proceedings under the Act, ethical investigations conducted by private professional organizations, or in the course of peer reviews.

Records and Work Papers

Upon request, a CPA or firm must, in all circumstances, provide to the client or former client any accounting or other records belonging to, or obtained from or on behalf of, the client that the CPA removed from the client's premises or received on behalf of the client.

In addition, for a reasonable charge, a CPA must furnish to his client or former client, upon request made within a reasonable time after original issuance of the document in question:

1) a copy of the client's tax return;
2) a copy of any report or other document previously issued by the certificate or registration holder to or for such client provided

that furnishing such reports to or for a client or former client would not cause the certificate or registration holder to be in violation of the portions of Section 501.60 of the Rules (relating to Auditing Standards) concerning subsequent events;

3) a copy of the certificate or registration holder's working papers, to the extent that such working papers include records which would ordinarily constitute part of the client's books and records and are not otherwise available to the client.

The Rules define working papers as "those papers developed by the certificate or registration holder incident to the performance of his engagement which do not result in changes to the client's records or are in part of the records ordinarily maintained by the client." Examples of working papers include but are not limited to the following:

- letters of confirmation and representation;
- excerpts of company documents;
- audit programs;
- internal memoranda;
- schedules;
- flowcharts; and
- narratives.

A CPA, when performing an engagement that is terminated prior to the completion of the engagement, is required to return or furnish the originals of only those records originally obtained by the certificate or registration holder from the client.

Examples of working papers which constitute client records include, but are not limited to:

- worksheets in lieu of books of original entry such as listings and distributions of cash receipts or cash disbursements;
- worksheets in lieu of general ledger or subsidiary ledgers, such as accounts receivable, job cost and equipment ledgers, or similar depreciation records;
- all adjusting and closing journal entries and supporting details when the supporting details are not fully set forth in the explanation of the journal entry; and

- consolidating or combining journal entries and worksheets and supporting detail in arriving at final figures incorporated in an end product such as financial statements or tax returns.

Documentation or working papers required by professional standards for attest services must be maintained in paper or electronic format by a CPA for a period of not less than five years from the date of any report issued in connection with the attest service, unless otherwise required by another regulatory body.

♦ Case Study ♦

July 2010

Investigation No.: 09-11-01L
Respondent: Janet Sue Martin
Hometown: Granbury
Certificate No.: 083430
Firm License No.: C06888
Rules Violations: 501.74, 501.76, 501.90(11)
Act Violation: 901.502(6)

Respondent entered into an Agreed Consent Order with the Board whereby Respondent would be reprimanded. In addition, Respondent must pay $4,500 in administrative penalties and $671.18 in administrative costs within 30 days of the date the Board ratified the order.

Respondent incorrectly prepared a client's 2006 and 2007 Form 1040 and 2007 Form 1041 tax returns. Respondent also failed to return the client's records and to respond to the client's inquiries.

Withdrawal or Resignation

The Rules state that if a CPA cannot complete an engagement or employment assignment in a manner that complies with the requirements, the CPA must withdraw from the engagement or resign from the employment assignment and inform either the client or employer (preferably in writing) of the withdrawal or resignation.

♦ Case Study ♦

March 2009

Investigation No.: 09-09-12L
Respondent: Ronald Paul Manner
Hometown: Houston
Certificate No.: 064796
Firm License No.: C04805
Rules Violations: 501.74, 501.78, 501.90(9), 501.90(11) and 501.93
Act Violations: 901.502(6) and 901.502(11)

Respondent entered into an Agreed Consent Order with the Board whereby Respondent's certificate was revoked in lieu of further disciplinary proceedings. In addition, Respondent must pay $640.94 in administrative costs within 30 days of the date the Board ratified the order.

Respondent failed to complete a client's tax engagement, failed to respond to the client's inquiries in a timely manner without good cause, and accepted a payment of $1,500 for services not rendered. In addition, Respondent failed to respond to the Board's communication dated September 16, 2009.

Practice of Public Accountancy

A CPA may not engage in the practice of public accountancy unless he holds a valid license issued by the Texas Board. If for any reason a CPAs license is revoked, they may not continue to use the title or designation "certified public accountant", the abbreviation "CPA", or any other title, designation, word, letter, abbreviation, sign, card, or device tending to indicate that the person is a certified public accountant.

A licensee who is not in the client practice of public accountancy may not in any manner, through use of the CPA designation or otherwise, claim or imply independence from his employer or that the licensee is in the client practice of public accountancy.

♦ Case Study ♦

November 2009

Investigation No.: 09-05-09L
Respondent: John Edward Turner
Hometown: Houston
Certificate No.: 025828
Firm License No.: C04784
Rules Violations: 501.80, 501.81, 527.4
Act Violation: 901.502(6)

Respondent entered into an Agreed Consent Order with the Board whereby Respondent was reprimanded. In addition, Respondent was required to pay an administrative penalty of $11,000 plus $451.32 in administrative costs within 30 days of the date the Board ratified the Board Order.

Respondent practiced public accountancy with a delinquent, expired license for approximately two years, practiced public accountancy in an unregistered entity, and failed to participate in the Board's peer review program for approximately two years.

Firm License Requirements

All CPA firms which establish or maintain an office in the state of Texas must have a current firm license issued by the Texas Board. In addition, a CPA is not permitted to provide attest services without holding a current firm license issued by the Texas Board.

Each advertisement or written promotional statement that refers to a CPA's designation and his or her association with an unlicensed entity in the client practice of public accountancy must include the disclaimer: "This firm is not a CPA firm." The disclaimer must be included in conspicuous proximity to the name of the unlicensed entity and be printed in type not less bold than that contained in the body of the advertisement or written statement. If the advertisement is in audio format only, the disclaimer shall be clearly declared at the conclusion of each such presentation.

The previous requirements do not apply with regard to a CPA performing services:

1) as a licensed attorney at law of this state while in the practice of law or as an employee of a licensed attorney when acting within the scope of the attorney's practice of law;
2) as an employee, officer, or director of a federally-insured depository institution, when lawfully acting within the scope of the legally permitted activities of the institution's trust department; or
3) pursuant to a practice privilege.

♦ Case Study ♦

July 2010

Investigation No.: 09-09-17L
Respondent: Garland Bruce Hilton
Hometown: Austin
Certificate No.: 056469
Firm License No.: T01393
Rules Violation: 501.81
Act Violation: 901.502(6)

Respondent entered into an Agreed Consent Order with the Board whereby Respondent was reprimanded. In addition, Respondent must pay $736.43 in administrative costs within 30 days of the Order.

Respondent practiced public accountancy with a suspended firm license from August 1998 until February 10, 2010.

Advertising

The Rules state that a CPA is not permitted to use or participate in the use of:

1) any written, oral, or electronic communication having reference to the person's professional services that contains a false, fraudulent, misleading or deceptive statement or claim; nor
2) any written, oral or electronic communication that refers to the person's professional services that is accomplished or accompanied by coercion, duress, compulsion, intimidation, threats, overreaching, or vexatious or harassing conduct.

In addition, it is a violation of the Rules for a CPA to persist in contacting a prospective client when the prospective client has made known to the CPA, or the CPA should have known the prospective client's desire not to be contacted by the person.

In the case of an electronic or direct mail communication, the CPA must retain a copy of the actual communication along with a list or other description of parties to whom the communication was distributed. Such copy must be retained by the person for a period of at least 36 months from the date of its last distribution. This Rule does not apply when:

1) the communication is made to anyone who is at that time a client of the person;
2) the communication is invited by anyone to whom it was made; or
3) the communication is made to anyone seeking to secure the performance of professional services.

In the case of broadcasting, the broadcast must be recorded and the CPA must retain a recording of the actual transmission for at least 36 months.

Firm Names

The following are the general Rules which are applicable to all CPA firms:

- A firm name may not contain words, abbreviations or other language that are misleading to the public, or that may cause confusion to the public as to the legal form or ownership of the firm.
- A firm licensed by the board may not conduct business, perform or offer to perform services for or provide products to a client under a name other than the name in which the firm is licensed.
- Prior to establishing a firm name, a CPA should refer to the Rules regarding several examples of words, abbreviations and other language which is presumed by the Board to be misleading.
- The names of a corporation, professional corporation, limited liability partnership, professional limited liability company or other similar legal forms of ownership must contain the form of ownership or an abbreviation thereof, such as "Inc.," "P.C.,"

"L.L.P." or "P.L.L.C."; except that a limited liability partnership organized before September 1, 1993 is not required to utilize the words "limited liability partnership" or any abbreviation thereof.

- The name of a firm that is a sole proprietor must contain the surname of the sole proprietor as it appears on the individual license issued to the sole proprietor by the board.
- A partner surviving the death of all other partners may continue to practice under the partnership name for up to two years after becoming a sole proprietor, but must notify the Board within 30 days.
- The name of any current or former owner may not be used in a firm name during any period when such owner is prohibited from practicing public accountancy and prohibited from using the title "certified public accountant," "public accountant" or any abbreviation thereof, unless specifically permitted by the board.
- A firm licensed by the board is required to report to the board any change in the legal organization of the firm and amend the firm name to comply with this section regarding firm names for the new organization within thirty days of the effective date of such change.

♦ Case Study ♦

March 2009

Investigation No.: 08-03-05L
Respondent: Daniel Peterson
Hometown: Dallas
Certificate No.: 033428
Firm License No.: C02083
Rules Violation: 501.83
Act Violation: 901.502(6)

Respondent entered into an Agreed Consent Order (ACO) with the Board whereby Respondent's license was revoked. In addition, Respondent must pay $2,000 in administrative penalties and $1,000 in administrative costs within 30 days of the date the Board ratified the order. Further, Respondent must pay $3,000 in administrative penalties within 90 days of the date the Board ratifies the order.

> Respondent maintained a firm name of Peterson and Company when Respondent was the only full-time employee of the firm who held a certificate issued by the Board. In addition, Respondent represented to the Board that two or more full-time employees of the firm held certificates issued by the Board.

Discreditable Acts

The Rules state that a person shall not commit any act that reflects adversely on that person's fitness to engage in the practice of public accountancy. A discreditable act includes but is not limited to:

1) fraud or deceit in obtaining a certificate as a certified public accountant or in obtaining registration under the Act or in obtaining a license to practice public accounting;
2) dishonesty, fraud or gross negligence in the practice of public accountancy;
3) violation of any of the provisions of Subchapter J or §901.458 of the Act applicable to a person certified or registered by the board;
4) final conviction of a felony or imposition of deferred adjudication or community supervision in connection with a criminal prosecution of a felony under the laws of any state or the United States;
5) final conviction of any crime or imposition of deferred adjudication or community supervision in connection with a criminal prosecution, an element of which is dishonesty or fraud under the laws of any state or the United States, a criminal prosecution for a crime of moral turpitude, a criminal prosecution involving alcohol abuse or controlled substances, or a criminal prosecution for a crime involving physical harm or the threat of physical harm;
6) cancellation, revocation, suspension or refusal to renew authority to practice as a certified public accountant or a public accountant by any other state for any cause other than failure to pay the appropriate registration fee in such other state;
7) suspension or revocation of or any consent decree concerning the right to practice before any state or federal regulatory or licensing body for a cause which in the opinion of the board warrants its action;

8) knowingly participating in the preparation of a false or misleading financial statement or tax return;
9) fiscal dishonesty or breach of fiduciary responsibility of any type;
10) failure to comply with a final order of any state or federal court;
11) repeated failure to respond to a client's inquiry within a reasonable time without good cause;
12) intentionally misrepresenting facts or making a misleading or deceitful statement to a client, the board, board staff or any person acting on behalf of the board;
13) giving intentional false sworn testimony or perjury in court or in connection with discovery in a court proceeding or in any communication to the board or any other federal or state regulatory or licensing body;
14) threats of bodily harm or retribution to a client;
15) public allegations of a lack of mental capacity of a client which cannot be supported in fact;
16) voluntarily disclosing information communicated to the person by an employer, past or present, or through the person's employment in connection with accounting services rendered to the employer, except:
    a) by permission of the employer;
    b) pursuant to the Government Code, Chapter 554 (commonly referred to as the "Whistle Blowers Act");
    c) pursuant to:
        (1) a court order signed by a judge; or
        (2) a summons
            (a) under the provisions of the Internal Revenue Code of 1986 and its subsequent amendments,
            (b) the Securities Act of 1933 (15 U.S.C. §77a et seq.) and its subsequent amendments, or
            (c) the Securities Exchange Act of 1934 (15 U.S.C. §78a et seq.) and its subsequent amendments;
    d) in an investigation or proceeding by the board;
    e) in an ethical investigation conducted by a professional organization of certified public accountants; or
    f) in the course of a peer review under Section 901.159 of the Public Accountancy Act; or

g) any information that is required to be disclosed by the professional standards for reporting on the examination of a financial statement.

17) breaching the terms of an agreed consent order entered by the board or violating any Board Order.

♦ Board Ruling ♦

The board has found that any crime of moral turpitude directly relates to the practice of public accountancy. A crime of moral turpitude is defined as a crime involving grave infringement of the moral sentiment of the community. The board has found that any crime involving alcohol abuse or controlled substances directly relates to the practice of public accountancy.

Case Studies

Date of Action	Violation	Action Taken
July 2010	Respondent failed to timely file his tax returns for tax years 2001, 2002, 2004, and 2005. On June 23, 2009, Respondent entered into an Agreement for Consent to Suspension from Practice with the IRS.	Respondent entered into an Agreed Consent Order with the Board whereby Respondent's certificate was revoked in lieu of further disciplinary proceedings. In addition, Respondent must pay $5,000 in administrative penalties and $559.29 in administrative costs within 30 days of the date the Board ratified the order.
July 2010	Respondent used his employer's company-issued credit card for personal expenditures.	Respondent entered into an Agreed Consent Order with the Board whereby Respondent's certificate was revoked. In addition, Respondent must pay an administrative penalty of $12,000 and $596.59 in administrative costs within 30 days of the date the Board ratified the Order.

March 2010	On October 29, 1974, Respondent was convicted of possession of marijuana, a misdemeanor offense. On October 3, 2008, Respondent was convicted of driving while intoxicated, a misdemeanor offense. Respondent failed to report the October 3, 2008, conviction within 30 days of the event.	Respondent entered into an Agreed Consent Order (ACO) with the Board whereby Respondent's individual license was suspended for two years; however, this suspension was stayed and Respondent was placed on probation for two years. In addition, Respondent must pay an administrative penalty of $1,000 and $594.34 in administrative costs within 30 days of the date the Board ratified the order.
March 2010	On March 23, 2001, Respondent pleaded nolo contendere to assault causing bodily injury-family member, a Class A misdemeanor. On August 12, 2009, Respondent pleaded nolo contendere to assault-bodily injury, a Class A misdemeanor offense. Respondent failed to report the March 23, 2001, conviction within 30 days of the event.	Respondent entered into an Agreed Consent Order (ACO) with the Board whereby Respondent's license was revoked for two years; however, this revocation was stayed and Respondent was placed on probation for two years. In addition, Respondent must pay an administrative penalty of $3,000 and $575.68 in administrative costs within 30 days of the date the Board ratified the order.
March 2010	Respondent misappropriated approximately $449,000.	Respondent entered into an Agreed Consent Order with the Board whereby Respondent's certificate was revoked in lieu of further disciplinary proceedings. In addition, Respondent must pay $307.62 in administrative costs within 30 days of the date the Board ratified the order.
March 2010	On June 23, 2009, Respondent was convicted of one count of theft valued at $200,000 or more, a first degree felony offense. On June 23, 2009, Respondent was convicted of one count of misapplication of	Respondent entered into an Agreed Consent Order with the Board whereby Respondent's certificate was revoked in lieu of further disciplinary proceedings. In addition, Respondent must pay $319.68 in administrative costs

	fiduciary property valued at $200,000 or more, a first degree felony offense.	within 30 days of the date the Board ratified the order.
March 2010	On July 24, 2007, Respondent pleaded guilty to the second degree felony, False Statement to Obtain Credit.	Respondent entered into an Agreed Consent Order with the Board whereby Respondent surrendered Respondent's certificate for revocation in lieu of further disciplinary proceedings. In addition, Respondent must pay $688.68 in administrative costs within 30 days of the date the Board ratified the order.
Novem-ber 2009	On July 8, 2009, Respondent pleaded no contest to cruelty to animals, a state jail felony.	Respondent entered into an Agreed Consent Order with the Board whereby Respondent's certificate was revoked in lieu of further disciplinary proceedings. In addition, Respondent was required to pay $195.36 in administrative costs within 30 days of the date the Board ratified the order.
May 2009	On October 1, 2007, respondent pleaded guilty to three counts of aggravated sexual assault, child under 14, a 1st degree felony.	Respondent entered into an Agreed Consent Order with the Board whereby respondent's certificate was revoked. Respondent was required to pay $319.68 in administrative costs within 30 days of the date the Board ratified the Board order.
Novem-ber 2008	On February 21, 2007, respondent pled nolo contendere to two counts of assault-family violence.	Respondent entered into an Agreed Consent Order with the Board whereby respondent would surrender his certificate for revocation in lieu of further disciplinary proceedings. In addition, respondent must pay $449.94 in administrative costs within 30 days of the date the Board ratified the order.

Reportable Events

A. A CPA must report in writing to the Board the occurrence of any of the following events within 30 days of the date the CPA has knowledge of these events:
   1) the conviction or imposition of deferred adjudication of the licensee of any of the following:
      - a felony;
      - a crime of moral turpitude;
      - any crime of which fraud or dishonesty is an element or that involves alcohol abuse or controlled substances; and
      - any crime related to the qualifications, functions, or duties of a public accountant or certified public accountant, or to acts or activities in the course and scope of the practice of public accountancy or as a fiduciary.
   2) the cancellation, revocation, or suspension of a certificate, other authority to practice or refusal to renew a certificate or other authority to practice as a certified public accountant or a public accountant, by any state, foreign country or other jurisdiction;
   3) the cancellation, revocation, or suspension of the right to practice as a certified public accountant or a public accountant before any governmental body or agency or other licensing agency;
   4) an unappealable adverse finding in any state or federal court or an agreed settlement in a civil action against the licensee concerning professional accounting services or professional accounting work; or
   5) the loss of a professional license from another state or federal regulatory agency such as an insurance license or a securities license, resulting from an unappealable adverse finding.

B. The report required by subsection (a) of this section shall be signed by the licensee and shall set forth the facts which constitute the reportable event. If the reportable event involves the action of an administrative agency or court, then the report shall set forth the title of the matter, court or agency name, docket number, and dates of occurrence of the reportable event.

C. Nothing in this section imposes a duty upon any licensee to report to the board the occurrence of any of the events set forth in subsection (a) of this section either by or against any other licensee.

D. As used in this section, a conviction includes the initial plea, verdict, or finding of guilt, plea of no contest, or pronouncement of sentence by a trial court even though that conviction may not be final or sentence may not be actually imposed until all appeals are exhausted.

E. Interpretive Comment: A crime of moral turpitude is defined in this chapter as a crime involving grave infringement of the moral sentiment of the community.

♦ Case Study ♦

November 2009

Investigation No.: 09-09-19L
Respondent: Clinton Wayne Putman
Hometown: Denison
Certificate No.: 086290
Rules Violations: 501.80, 501.90(4), 501.91
Act Violations: 901.502(6), 901.502(10), 901.502(11)

Respondent entered into an Agreed Consent Order with the Board whereby Respondent's certificate was revoked in lieu of further disciplinary proceedings. In addition, Respondent was required to pay $213.12 in administrative costs within 30 days of the date the Board ratified the Board Order.

On December 4, 2008, Respondent was convicted of two counts of possession of a controlled substance, PG1<1G, in a drug-free zone, a third-degree felony offense. Respondent failed to report this conviction within 30 days of the event. Further, Respondent practiced public accountancy with a delinquent, expired license.

Frivolous Complaints

A person who, in writing to the Board, accuses another person of violating the rules of the Board must assist the Board in any investigation and/or prosecution resulting from the written accusation. Failure to do so, such as not appearing to testify at a hearing or to produce requested documents necessary to the investigation or prosecution, without good cause, is a violation of this rule. A person who makes a complaint against another person that is groundless and brought in bad faith, for the purpose of harassment, or for any other improper purpose shall be in violation of this Rule.

Responses

A person shall substantively respond in writing to any communication from the Board requesting a response, within 30 days. The Board may specify a shorter time for response in the communication when circumstances so require. The time to respond shall commence on the date the communication was mailed, delivered to a courier or delivery service, faxed or e-mailed to the last address, facsimile number, or e-mail address furnished to the Board by the applicant or person.

A person shall provide copies of documentation and/or work papers in response to the Board's request at no expense to the Board within 30 days. The Board may specify a shorter time for response in the communication when circumstances so require. The time to respond shall commence on the date the request was mailed, delivered to a courier or delivery service, faxed or e-mailed to the last address, facsimile number or e-mail address furnished to the Board by a person. A person may comply with this subsection by providing the Board with original records for the Board to duplicate. In such a circumstance, upon request the Board will provide an affidavit from the custodian of records documenting custody and control of the records.

Failure to timely respond substantively to written communications, or failure to furnish requested documentation and/or work papers, constitutes conduct indicating lack of fitness to serve the public as a professional accountant.

Each applicant and each person required to be registered with the Board under the Act shall notify the Board, either in writing or through the Board's website, of any and all changes in either such person's mailing address or telephone number and the effective date thereof within 30 days before or after such effective date.

♦ Case Study ♦

March 2009

Investigation Nos.: 09-10-01L and 09-10-02L
Respondents: Norberto Perez and Norberto Perez, CPA (firm)
Hometown: Brownsville
License Nos.: 039235, C05089
Rules Violations: 501.93(c), 501.94, 527.5
Act Violations: 901.502(6), 901.502(11), 901.502(12)

Respondent Perez entered into an Agreed Consent Order with the Board on behalf of himself and Respondent firm whereby Respondent Perez and Respondent firm were placed on limited scope. Respondent Perez, Respondent firm, and any successor firms are prohibited from performing audits. All reviews and compilations with disclosures performed by Respondent Perez, Respondent firm, and any successor firms are subject to pre-issuance review. In addition, Respondent Perez's individual license is subject to a three-year probated revocation, and he must pay $2,929.53 in administrative costs within seven months of the date the Board ratified the order.

Respondent firm has received three consecutive peer reviews with a rating of modified or adverse. Respondent firm failed to timely perform the following corrective actions ordered by the Board: All professional staff who perform attest engagements were to take 20 hours of live CPE by January 31, 2009, and have a pre-issuance review by June 30, 2009, and an accelerated peer review resulting in a passing rating by July 31, 2009. Respondent Perez is responsible for the activities of Respondent firm in accordance with the provision in Board Rule 513.15(d) regarding resident manager's responsibility.

Mandatory Continuing Professional Education

Each certificate or registration holder shall comply with the mandatory continuing professional education reporting and the mandatory continuing professional education attendance requirements.

A licensee shall complete at least 120 hours of CPE in each three-year period, and a minimum of 20 hours in each one-year period. CPE, except as provided by board rule shall be offered by board contracted CPE sponsors. The exception to this requirement is an initial licensee, one who has been certified or registered for less than 12 months. A licensee may not claim more than fifty percent of the total CPE credit hours required from the non-technical area in a three year reporting period.

A licensee shall retain documents or other evidence supporting CPE credit hours claimed for the three most recent full reporting periods to the date the credit hours are reported to the board, and shall submit the supporting evidence to the board if such data is specifically requested.

Once an individual's license has been suspended a third time by the board for failing to complete the 120 hours of continuing professional education, the individual's certificate shall be subject to revocation and may not be reinstated for at least 12 months from the date of the revocation.

For additional information on the Texas Board and its enforcement process, see www.tsbpa.state.tx.us. On the home page, scroll down to QUICK LINKS and then click on TEXAS STATE BOARD REPORTS. This newsletter is distributed to all Texas CPAs and contains summaries of the Board's recent sanctions.

Case Studies

In each of the following fictitious scenarios, please decide which if any of the Texas Rules of Professional Conduct have been violated.

♦ Case Study ♦

Joe Smith, a CPA, was employed at a nonprofit organization, which offered services free of charge to single mothers that needed assistance. The nonprofit received a majority of its funds through grants which were approved by the state of Texas. It was Joe's job to complete the grant request applications each year and provide the supporting documents necessary to get the grants reapproved. This year was an exceptional year, as the nonprofit had received a very generous donation from one contributor. The problem was that if Joe reported this contribution in the financial statements that he submitted to the state, it was very possible that the state would not reapprove the nonprofit's grant for next year.

Joe discussed this issue with the board of directors, who then encouraged him to falsify the date that the large contribution was received, to make it appear that it was not received until the following year. Hesitant, but fearful of losing his job, Joe did as the board requested and filed the documents with the state knowing that the financial statements were not reported in accordance with GAAP.

What Rules do you feel that Joe has violated?

In addition to the criminal acts which Joe has committed, Joe has violated the professional standards in the Rules. By fraudulently reporting the date that the contribution was received, he has acted without integrity and also committed discreditable acts under the Rules.

♦ Case Study ♦

Ann Jones, A CPA in public practice, was asked to perform an audit of a public utility company. Although Ann had been a CPA for five years, she just recently opened her practice and had no experience performing audits or working with public utilities companies. Ann was the only employee of her firm and was concerned as to whether she could complete the audit appropriately. On the other hand, she really needed the money and this would be her first big client.

Ann accepted the engagement and decided to lie to the client by telling them that she had performed several audits of this size in the past and had also specialized in public utilities companies.

What Rules do you feel that Ann has violated?

Ann has violated the Rules of competency by accepting an engagement that she knew she was not experienced enough to perform. In addition she also made false statements to her client regarding her prior experience and qualifications. These actions would violate the Rules for advertising and discreditable acts. Ann was required by the Rules to withdraw from this engagement.

♦ Case Study ♦

Brian Lowes, a CPA and professor at a large university, had become so busy teaching in the past year that he had not had time to complete his continuing education requirements. Although he received his notice from the TSBPA to report his CPE and renew his CPA license, Brian kept putting it off and now his CPA license had expired. The TSBPA had since sent him several notices, but those too had gotten piled up on his desk and he had yet to respond to their inquiries.

Brian knew that he could not now practice with a delinquent license, but that would mean having to let the university know of his lapse in judgment and he would most certainly have to resign from his position. Instead, Brian decided to continue to refer to himself as a CPA and keep teaching. He vowed that he would deal with clearing the matter up with the TSBPA as soon as he had some available time.

What Rules do you feel that Brian has violated?

Brian has obviously not met the CPE requirements of the Rules. In addition, he has been teaching with a delinquent license and held himself out to be certified, although he was aware that his license had expired. Acting without integrity, committing discreditable acts and not responding to TSBPA inquiries could also be added to the Rules violations which Brian has committed.

♦ Case Study ♦

Becky Lewis, a CPA employed as an internal auditor for a manufacturing plant, is vying for the position of internal audit manager. She has worked for the company for over 10 years and feels she deserves the position. The problem is that one of her co-workers, Sally Cramer, has also been with the company for ten years and feels she deserves the position even more.

Becky is fearful that Sally will be offered the position, because Sally gets along better with the rest of the staff and might be able to manage them better. Becky decides the only way to ensure that Sally will not get the promotion, is if Becky can discredit her in some way. After much thought, Becky decides to modify some of the internal audit reports that Sally had prepared, making it appear that Sally had made fraudulent statements. In addition, Becky decided to write a letter to the TSBPA and claim that Sally had violated the Rules by making false statements and preparing fraudulent reports.

What Rules do you feel that Becky has violated?

Besides acting without integrity, Becky has also committed fraudulent and discreditable acts and made a frivolous complaint to the Board.

Appendix

Letter purportedly written by Sherron Watkins to Kenneth Lay

Dear Mr. Lay,

Has Enron become a risky place to work? For those of us who didn't get rich over the last few years, can we afford to stay?

Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting – most notably the Raptor transactions and the Condor vehicle. We do have valuation issues with our international assets and possibly some of our EES MTM positions.

The spotlight will be on us, the market just can't accept that Skilling is leaving his dream job. I think that the valuation issues can be fixed and reported with other goodwill write-downs to occur in 2002. How do we fix the Raptor and Condor deals? They unwind in 2002 and 2003, we will have to pony up Enron stock and that won't go unnoticed.

To the layman on the street, it will look like we recognized funds flow of $800 mm from merchant asset sales in 1999 by selling to a vehicle (Condor) that we capitalized with a promise of Enron stock in later years. Is that really funds flow or is it cash from equity issuance?

We have recognized over $550 million of fair value gains on stocks via our swaps with Raptor, much of that stock has declined significantly – Avici by 98%, from $178 mm to $5 mm, The New Power Co by 70%, from $20/share to $6/share. The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.

I am incredibly nervous that we will implode in a wave of accounting scandals. My 8 years of Enron work history will be worth nothing on my resume, the business world will consider the past successes as nothing but an elaborate accounting hoax. Skilling is resigning now for 'personal reasons' but I think he wasn't having fun, looked down the road and knew this stuff was unfixable and would rather abandon ship now than resign in shame in 2 years.

Is there a way our accounting guru's can unwind these deals now? I have thought and thought about how to do this, but I keep bumping into one big problem – we booked the Condor and Raptor deals in 1999 and 2000, we enjoyed a wonderfully high stock price, many executives sold stock, we then try and reverse or fix the deals in 2001 and it's a bit like robbing the bank in one year and trying to pay back it back 2 years later. Nice try, but investors were hurt, they bought at $70 and $80/share looking for $120/share and now they're at $38 or worse. We are under too much scrutiny and there are probably one or two disgruntled 'redeployed' employees who know enough about the 'funny' accounting to get us in trouble.

What do we do? I know this question cannot be addressed in the all employee meeting, but can you give some assurances that you and Causey will sit down and take a good hard objective look at what is going to happen to Condor and Raptor in 2002 and 2003?

Appendix

Summary of alleged issues:

Raptor

Entity was capitalized with LJM equity. That equity is at risk; however, the investment was completely offset by a cash fee paid to LJM. If the Raptor entities go bankrupt LJM is not affected, there is no commitment to contribute more equity.

The majority of the capitalization of the Raptor entities is some form of Enron N/P, restricted stock and stock rights.

Enron entered into several equity derivative transactions with the Raptor entities locking in our values for various equity investments we hold.

As disclosed, in 2000, we recognized $500 million of revenue from the equity derivatives offset by market value changes in the underlying securities.

This year, with the value of our stock declining, the underlying capitalization of the Raptor entities is declining and Credit is pushing for reserves against our MTM positions.

To avoid such a write-down or reserve in Q1 2001, we 'enhanced' the capital structure of the Raptor vehicles, committing more ENE shares.

My understanding of the Q3 problem is that we must 'enhance' the vehicles by $250 million.

I realize that we have had a lot of smart people looking at this and a lot of accountants including AA&Co. have blessed the accounting treatment. None of that will protect Enron if these transactions are ever disclosed in the bright light of day. (Please review the late 90's problems of Waste Management – where AA paid $130+ mm in litigation re: questionable accounting practices).

The overriding basic principle of accounting is that if you explain the 'accounting treatment' to a man on the street, would you influence his investing decisions? Would he sell or buy the stock based on a thorough understanding of the facts? If so, you best present it correctly and/or change the accounting.

My concern is that the footnotes don't adequately explain the transactions. If adequately explained, the investor would know that the "Entities" described in our related party footnote are thinly capitalized, the equity holders have no skin in the game, and all the value in the entities comes from the underlying value of the derivatives (unfortunately in this case, a big loss) AND Enron stock and N/P. Looking at the stock we swapped, I also don't believe any other company would have entered into the equity derivative transactions with us at the same prices or without substantial premiums from Enron. In other words, the $500 million in revenue in 2000 would have been much lower. How much lower?

Raptor looks to be a big bet, if the underlying stocks did well, then no one would be the wiser. If Enron stock did well, the stock issuance to these entities would decline and the transactions would be less noticeable. All has gone against us. The stocks, most notably Hanover, The New Power Co., and Avici are underwater to great or lesser degrees.

I firmly believe that executive management of the company must have a clear and precise knowledge of these transactions and they must have the transactions reviewed by objective experts in the fields of securities law and accounting. I believe Ken Lay deserves the right to judge for himself what he believes the probabilities of discovery to be and the estimated damages to the company from those discoveries and decide one of two courses of action:

1. The probability of discovery is low enough and the estimated damage too great; therefore we find a way to quietly and quickly reverse, unwind, write down these positions/transactions.
2. The probability of discovery is too great, the estimated damage to the company too great; therefore, we must quantify, develop damage containment plans and disclose.

I firmly believe that the probability of discovery significantly increased with Skilling's shocking departure. Too many people are looking for a smoking gun.

Appendix

Summary of Raptor oddities:

1. The accounting treatment looks questionable.

    a. Enron booked a $500 mm gain from equity derivatives from a related party.
    b. That related party is thinly capitalized, with no party at risk except Enron.
    c. It appears Enron has supported an income statement gain by a contribution of its own shares.

    One basic question: The related party entity has lost $500 mm in its equity derivative transactions with Enron. Who bears that loss? I can't find an equity or debt holder that bears that loss. Find out who will lose this money. Who will pay for this loss at the related party entity?

    If it's Enron, from our shares, then I think we do not have a fact pattern that would look good to the SEC or investors.

2. The equity derivative transactions do not appear to be at arms length.

    a. Enron hedged New Power, Hanover, and Avici with the related party at what now appears to be the peak of the market. New Power and Avici have fallen away significantly since. The related party was unable to lay off this risk. This fact pattern is once again very negative for Enron.
    b. I don't think any other unrelated company would have entered into these transactions at these prices. What else is going on here? What was the compensation to the related party to induce it to enter into such transactions?

3. There is a veil of secrecy around LJM and Raptor. Employees question our accounting propriety consistently and constantly. This alone is cause for concern.

    a. Jeff McMahon was highly vexed over the inherent conflicts of LJM. He complained mightily to Jeff Skilling and laid out 5 steps he thought should be taken if he was to remain as Treasurer. 3 days later, Skilling offered him the CEO spot at Enron Industrial Markets and never addressed the 5 steps with him.
    b. Cliff Baxter complained mightily to Skilling and all who would listen about the inappropriateness of our transactions with LJM.
    c. I have heard one manager level employee from the principle investments group say "I know it would be devastating to all of us, but I wish we would get caught. We're such a crooked company." The principle investments group hedged a large number of their investments with Raptor. These people know and see a lot. Many simular comments are made when you ask about these deals. Employees quote our CFO as saying that he has a handshake deal with Skilling that LJM will never lose money.

4. Can the General Counsel of Enron audit the deal trail and the money trail between Enron and LJM/Raptor and its principals? Can he look at LJM? At Raptor? If the CFO says no, isn't that a problem?

Condor and Raptor work:

1. Postpone decision on filling office of the chair, if the current decision includes CFO and/or CAO.

2. Involve Jim Derrick and Rex Rogers to hire a law firm to investigate the Condor and Raptor transactions to give Enron attorney client privilege on the work product. (Can't use V&E due to conflict – they provided some true sale opinions on some of the deals).

3. Law firm to hire one of the big 6, but not Arthur Andersen or PricewaterhouseCoopers due to their conflicts of interest: AA&Co (Enron); PWC (LJM).

4. Investigate the transactions, our accounting treatment and our future commitments to these vehicles in the form of stock, N/P, etc..
For instance: In Q3 we have a $250 mm problem with Raptor 3 (NPW) if we don't 'enhance' the capital structure of Raptor 3 to commit more ENE shares. By the way: in Q1 we enhanced the Raptor 3 deal, committing more ENE shares to avoid a write down.

5. Develop clean up plan:

   a. Best case: Clean up quietly if possible.

   b. Worst case: Quantify, develop PR and IR campaigns, customer assurance plans (don't want to go the way of Salomon's trading shop), legal actions, severance actions, disclosure.

6. Personnel to quiz confidentially to determine if I'm all wet:
   a. Jeff McMahon
   b. Mark Koenig
   c. Rick Buy
   d. Greg Whalley

Appendix

To put the accounting treatment in perspective I offer the following:

1. We've contributed contingent Enron equity to the Raptor entities. Since it's contingent, we have the consideration given and received at zero. We do, as Causey points out, include the shares in our fully diluted computations of shares outstanding if the current economics of the deal imply that Enron will have to issue the shares in the future. This impacts 2002 – 2004 EPS projections only.

2. We lost value in several equity investments in 2000. $500 million of lost value. These were fair value investments, we wrote them down. However, we also booked gains from our price risk management transactions with Raptor, recording a corresponding PRM account receivable from the Raptor entities. That's a $500 million related party transaction – it's 20% of 2000 IBIT, 51% of NI pre tax, 33% of NI after tax.

3. Credit reviews the underlying capitalization of Raptor, reviews the contingent shares and determines whether the Raptor entities will have enough capital to pay Enron its $500 million when the equity derivatives expire.

4. The Raptor entities are technically bankrupt; the value of the contingent Enron shares equals or is just below the PRM account payable that Raptor owes Enron. Raptor's inception to date income statement is a $500 million loss.

5. Where are the equity and debt investors that lost out? LJM is whole on a cash on cash basis. Where did the $500 million in value come from? It came from Enron shares. Why haven't we booked the transaction as $500 million in a promise of shares to the Raptor entity and $500 million of value in our "Economic Interests" in these entities? Then we would have a write down of our value in the Raptor entities. We have not booked the latter, because we do not have to yet. Technically, we can wait and face the music in 2002 – 2004.

6. The related party footnote tries to explain these transactions. Don't you think that several interested companies, be they stock analysts, journalists, hedge fund managers, etc., are busy trying to discover the reason Skilling left? Don't you think their smartest people are pouring over that footnote disclosure right now? I can just hear the discussions – "It looks like they booked a $500 million gain from this related party company and I think, from all the undecipherable ½ page on Enron's contingent contributions to this related party entity, I think the related party entity is capitalized with Enron stock." ..... "No, no, no, you must have it all wrong, it can't be that, that's just too bad, too fraudulent, surely AA&Co wouldn't let them get away with that?" ..... "Go back to the drawing board, it's got to be something else. But find it!" ...... "Hey, just in case you might be right, try and find some insiders or 'redeployed' former employees to validate your theory."