

**VISION 20/20**

## ***Ethical Traps: Let's Examine Some Recent Real World Cases***

**Dave Cotton, CPA, CFE, CGFM**

**Cotton & Company LLP**

**Alexandria, Virginia**

**[www.cottoncpa.com](http://www.cottoncpa.com)**

**Cotton &  
Company**

**DAVID L. COTTON, CPA, CFE, CGFM**  
**COTTON & COMPANY LLP CHAIRMAN**

Dave Cotton is chairman of Cotton & Company LLP, Certified Public Accountants, headquartered in Alexandria, Virginia. The firm was founded in 1981 and has a practice concentration in assisting Federal and State government agencies, inspectors general, and government grantees and contractors with a variety of government program-related assurance and advisory services. Cotton & Company has performed grant and contract, indirect cost rate, financial statement, financial related, and performance audits for more than two dozen Federal inspectors general as well as numerous other Federal and State agencies and programs.

Cotton & Company's Federal agency audit clients have included the U.S. Government Accountability Office, U.S. Navy, U.S. Marine Corps, U.S. Transportation Command, U.S. House of Representatives, U.S. Capitol Police, U.S. Small Business Administration, U.S. Bureau of Prisons, Millennium Challenge Corporation, U.S. Marshals Service, and Bureau of Alcohol, Tobacco, Firearms and Explosives. Cotton & Company also assists numerous Federal agencies in preparing financial statements and improving financial management, accounting, and internal control systems.

Dave received a BS in mechanical engineering (1971) and an MBA in management science and labor relations (1972) from Lehigh University in Bethlehem, PA. He also pursued graduate studies in accounting and auditing at the University of Chicago Graduate School of Business (1977 to 1978). He is a Certified Public Accountant (CPA), Certified Fraud Examiner (CFE), and Certified Government Financial Manager (CGFM).

Dave served on the Advisory Council on Government Auditing Standards (the Council advises the United States Comptroller General on promulgation of **Government Auditing Standards**—GAO's yellow book) from 2006 to 2009. He served on the Institute of Internal Auditors (IIA) Anti-Fraud Programs and Controls Task Force and co-authored **Managing the Business Risk of Fraud: A Practical Guide**. He served on the American Institute of CPAs Anti-Fraud Task Force and co-authored **Management Override: The Achilles Heel of Fraud Prevention**. Dave is the past-chair of the AICPA Federal Accounting and Auditing Subcommittee and has served on the AICPA Governmental Accounting and Auditing Committee and the Government Technical Standards Subcommittee of the AICPA Professional Ethics Executive Committee. Dave chaired the Fraud Risk Management Task Force, sponsored by COSO and ACFE and is a principal author of the **COSO-ACFE Fraud Risk Management Guide**.

Dave served on the board of the Virginia Society of Certified Public Accountants (VSCPA) and on the VSCPA Litigation Services, Professional Ethics, Quality Review, and Governmental Accounting and Auditing Committees. He is a member of the Association of Government Accountants (AGA) and past-advisory board chairman and past-president of the AGA Northern Virginia Chapter and currently serves on the AGA Professional Ethics Board. He is also a member of the Institute of Internal Auditors and the Association of Certified Fraud Examiners (ACFE).

Dave has testified as an expert in governmental accounting, auditing, and fraud issues before the United States Court of Federal Claims and other administrative and judicial bodies.

Dave has spoken frequently on cost accounting, professional ethics, and auditor fraud detection responsibilities under SAS 99, *Consideration of Fraud in a Financial Statement Audit*. He has been an instructor for the George Washington University masters of accountancy program (**Fraud Examination and Forensic Accounting**), and has instructed for the George Mason University Small Business Development Center (**Fundamentals of Accounting for Government Contracts**).

Dave was the recipient of the ACFE 2018 Certified Fraud Examiner of the Year Award ("presented to a CFE who has demonstrated outstanding achievement in the field of fraud examination ... based on their contributions to the ACFE, to the profession, and to the community"); AGA's 2012 Educator Award ("to recognize individuals who have made significant contributions to the education and training of government financial managers"); and AGA's 2006 Barr Award ("to recognize the cumulative achievements of private sector individuals who throughout their careers have served as a role model for others and who have consistently exhibited the highest personal and professional standards").

# VISION 20/20

## Ethical Traps: Let's Examine Some Recent Real World Cases



- The AICPA Conceptual Framework—the Threats and Safeguards Approach to Ethical Compliance
- The 7 Threats to Independence
- Conflicts of Interest vs. Independence
- Let's Take a Look at Some Recent Cases

<sup>1</sup> Cotton & Company

## Please Note



***The views expressed in this presentation are my views and do not represent the official views of the AGA Professional Ethics Board***

<sup>2</sup> Cotton & Company

## AICPA Conceptual Framework

Identify Ethical Threat

Cotton  
Company

## The 7 Threats to Independence

- Adverse Interest
- Advocacy
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence

Cotton  
Company

## Adverse Interest

The threat that a member will not act with objectivity because the member's interests are opposed to the client's interests. E.g.:

- Your audit client or a shareholder threatens to sue you unless to render a certain opinion ...
- A client or officer, director or significant shareholder sues your firm ...

## Advocacy

The threat that a member will promote a client's interests or position to the point that his or her objectivity or independence is compromised. E.g.:

- You provide forensic accounting services for a client in litigation or in a dispute with 3<sup>rd</sup> parties ...
- You endorse a client's services or products ...

## Familiarity

The threat that, due to a long or close relationship with a client, a member will become too sympathetic to the client's interests or too accepting of the client's work or product. E.g.:

- One of your close relatives or a close friend is employed by the client ...
- One of your former partners or a former professional employee takes a key position with the client ...

Cotton  
Company

## Management Participation

The threat that a member will take on the role of client management or otherwise assume management responsibilities. E.g.:

- Your firm was previously retained by the client to design its accounting policies and procedures ...
- Your client lost its CFO suddenly and asked your firm to take over that role until they found a new CFO ...

Cotton  
Company

## Self-interest

The threat that a member could benefit, financially or otherwise, from an interest in, or relationship with, a client or persons associated with the client. E.g.:

- You have a financial interest in a client and the outcome of your engagement with the client may affect the value of that financial interest ...
- Excessive reliance exists on revenues from a single client ...

## Self-Review

The threat that a member will not appropriately evaluate the results of a previous judgment made or service performed or supervised by the member or an individual in the member's firm and that the member will rely on that service in forming a judgment as part of another service. E.g.:

- Your firm provided bookkeeping services for a client ...
- One of your partners was formerly a key employee of the client ...

## Undue Influence

The threat that a member will subordinate his or her judgment to an individual associated with a client or any relevant third party due to that individual's reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the member. E.g.:

- Your firm is threatened with dismissal from a client engagement ...
- The client indicates that your firm will not get future work if you continue to disagree on accounting matters ...

 Cotton Company

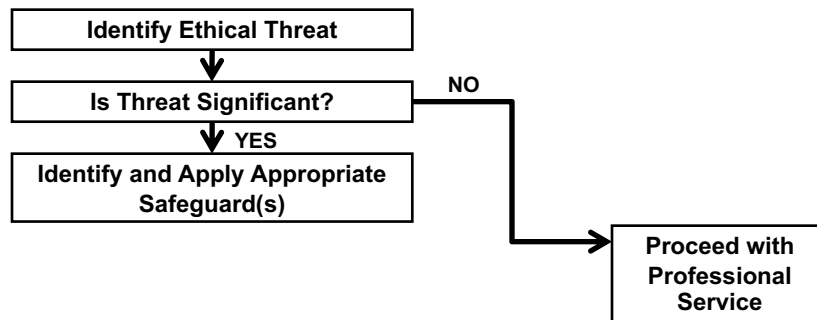
## The 6 Threats to Complying with Other Parts of the Code

- Adverse Interest
- Advocacy
- Familiarity
- ~~Management Participation~~
- Self-Interest
- Self-Review
- Undue Influence

 Cotton Company



## AICPA Conceptual Framework



Cotton  
Company

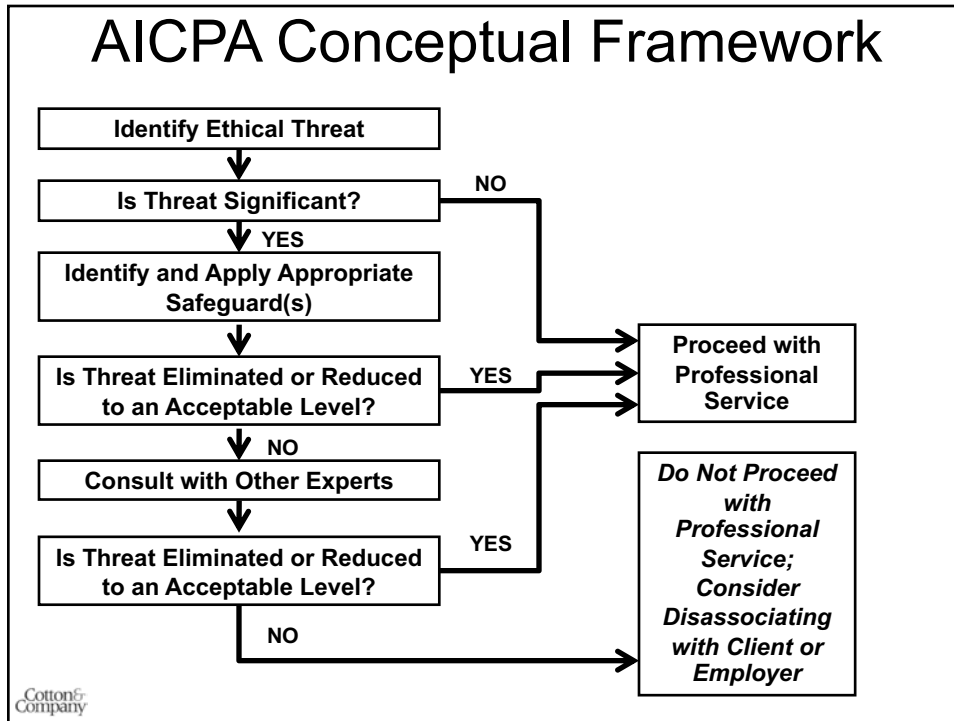
## Safeguards

An action or control that will tend to mitigate a threat.  
There are 3 broad categories

- Safeguards created by the profession, legislation, or regulation.
- Safeguards implemented by the client. (It is not possible to rely solely on safeguards implemented by the client to eliminate or reduce significant threats to an acceptable level.)
- Safeguards implemented by the firm, including policies and procedures to implement professional and regulatory requirements.

Cotton  
Company

# VISION 20/20



## AICPA Threats vs. Yellow Book Threats

AICPA	Yellow Book
• Adverse Interest	• <del>Adverse Interest</del>
• Advocacy	• <del>Advocacy</del>
• Familiarity	• Familiarity
• Management Participation	• Management Participation
• Self-Interest	• Self-Interest
• Self-Review	• Self-Review
• Undue Influence	• Undue Influence
	• Bias
	• Structural

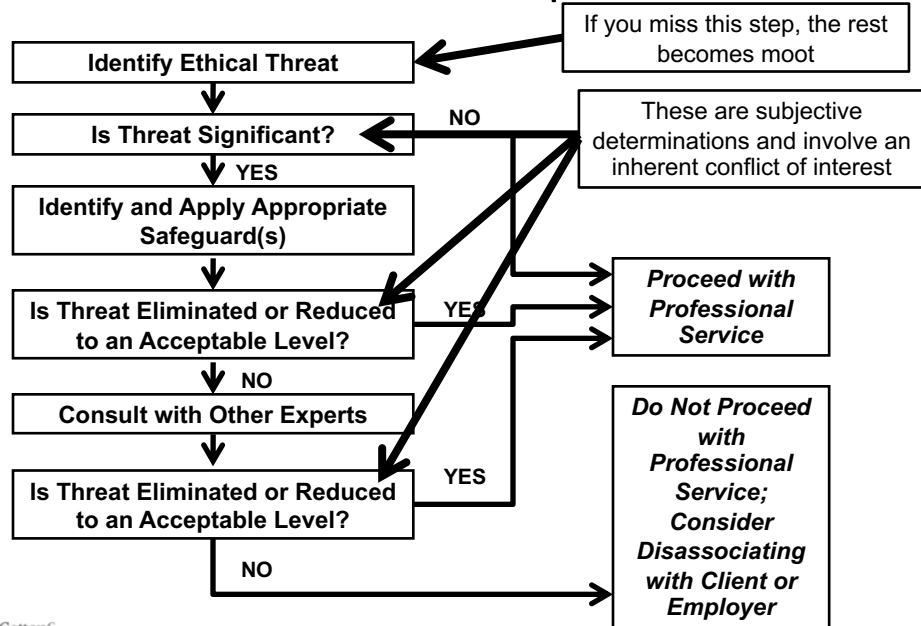
Cotton Company

## Yellow Book Threats

- **Bias threat** – the threat that an auditor will, as a result of political, ideological, social, or other convictions, take a position that is not objective.
- **Structural threat** – the threat that an audit organization's placement within a government entity, in combination with the structure of the government entity being audited, will affect the audit organization's ability to perform work and report results objectively.

Cotton  
Company

## Problems with the Conceptual Framework



Cotton  
Company

## The 7 Threats to Independence

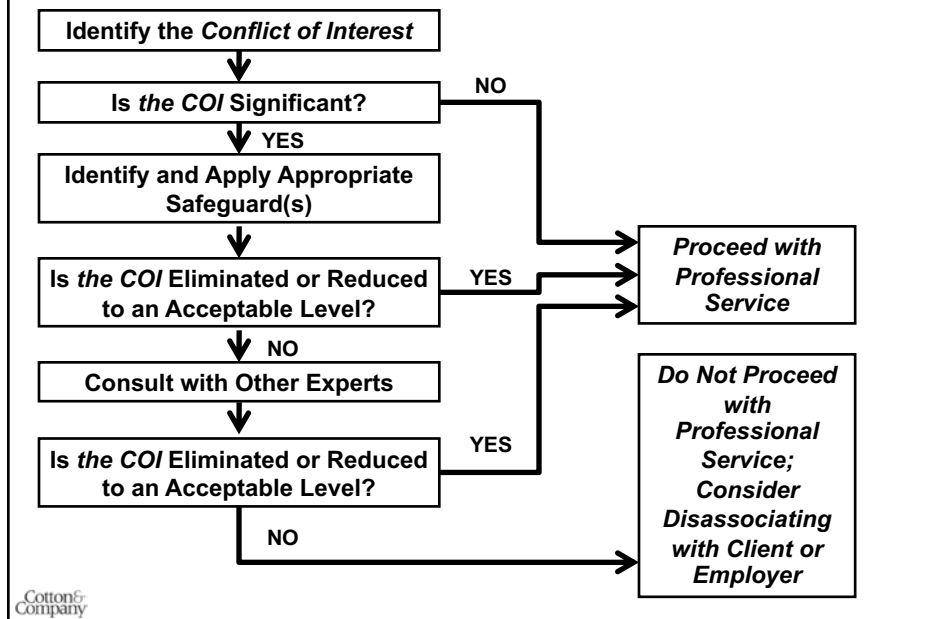
- Adverse Interest
- Advocacy
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence

***ALL of these  
are simply  
conflicts of  
interest ...***

***While there is some  
benefit to identifying the 7  
categories of conflicts of  
interest, should there be a  
Code rule that simply  
deals with conflicts of  
interest?***

Cotton  
Company

## AICPA Conceptual Framework



Cotton  
Company

## There are Actually Separate Code Sections that Cover COIs

1.110 Conflicts of Interest

1.110.010 Conflicts of Interest for Members in Public Practice

.12 When a conflict of interest exists, the member should disclose the nature of the conflict of interest to clients and other appropriate parties affected by the conflict and obtain their consent to perform the professional services. *The member should disclose the conflict of interest and obtain consent even if the member concludes that threats are at an acceptable level.*

 Cotton Company

## There are Actually Separate Code Sections that Cover COIs

2.110 Conflicts of Interest

2.110.010 Conflicts of Interest for Members in Business

.11 When a conflict of interest exists, the member should disclose the nature of the conflict to the relevant parties, including to the appropriate levels within the employing organization and obtain their consent to undertake the professional service. *The member should disclose the conflict of interest and obtain consent even if the member concludes that threats are at an acceptable level.*

 Cotton Company

# VISION 20/20

Oddly, however, the Code does not define a COI



1. A situation that has the potential to undermine the impartiality of a person because of the possibility of a clash between the person's self-interest and professional interest or public interest.
2. A situation in which a party's responsibility to a second-party limits its ability to discharge its responsibility to a third-party.

Cotton  
Company

## Other Professionals' Ethical Lapses

- Attorneys and Investigators
- Engineers
- Journalists
- Medical Researchers
- Prosecutors
  
- The Sad, Sad Case of Arthur Andersen

Cotton  
Company

## Lawyers and Investigators



***Peter Strzok***

***Lisa Page***

Cotton  
Company

## Lawyers and Investigators

THE WALL STREET JOURNAL.

- Before the election, “Strzok and Page discussed serving to ‘protect the country from the menace’ of Trump ‘enablers,’ and the possibility of an ‘insurance policy’ against the ‘risk’ of a Trump presidency.”
- “After the 2016 election, Mr. Strzok wrote, ‘OMG I am so depressed.’ Ms. Page replied, ‘I don’t know if I can eat. I am very nauseous.’”

Cotton  
Company

## The DOJ Ethics Handbook

- General Principle 8: “Employees shall act impartially and not give preferential treatment to any private organization or individual.”
- “Most Employees May:”
  - Express opinions on political subjects and candidates”

“\* ... employees of the Criminal Division, the FBI, ... are further restricted with regard to political activities, and may NOT engage in many of these actions. These employees should seek specific guidance ...”

How would Strzok and Page measure up against  
OUR code of ethics?



# VISION 20/20

## AICPA Threats vs. Yellow Book Threats

### AICPA

- Adverse Interest
- Advocacy
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence

### Yellow Book

- ~~Adverse Interest~~
- ~~Advocacy~~
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence
- Bias
- Structural

Cotton  
Company

## Adverse Interest

***The threat that a member will not act with objectivity*** because the member's interests are opposed to the client's interests. E.g.:

- Your audit client or a shareholder threatens to sue you unless to render a certain opinion ...
- A client or officer, director or significant shareholder sues your firm ...

***Conflict of Interest?***

Cotton  
Company

## Yellow Book Threats

- **Bias threat** – the threat that an auditor will, as a result of political, ideological, social, or other convictions, take a position that is not objective.

***Conflict of Interest?***

## Engineers and the “Diesel Dupe”

**BBC**

### Volkswagen: The scandal explained

By Russell Hotten  
Business reporter, BBC News

© 10 December 2015

f t s e Share



GETTY IMAGES

## Engineers and the “Diesel Dupe”

**BBC**

It's been dubbed the "diesel dupe". In September, **the Environmental Protection Agency (EPA) found** that many VW cars being sold in America had a "defeat device" - or software - in diesel engines that could detect when they were being tested, changing the performance accordingly to improve results. The German car giant has since admitted cheating emissions tests in the US.

When the cars were operating under controlled laboratory conditions - which typically involve putting them on a stationary test rig - the device appears to have put the vehicle into a sort of safety mode in which the engine ran below normal power and performance. Once on the road, the engines switched out of this test mode.

Cotton  
Company

## An Ethical Breach, Per the **ASCE** AMERICAN SOCIETY OF CIVIL ENGINEERS

Canon 6 of ASCE's Code of Ethics: "Engineers shall act in such a manner as to uphold and enhance the honor, integrity, and dignity of the engineering profession and shall act with zero tolerance for bribery, fraud, and corruption."

"Engineers shall not knowingly engage in business or professional practices of a fraudulent, dishonest, or unethical nature."

Cotton  
Company

# VISION 20/20

How would the VW engineers measure up against OUR code of ethics?

Cotton  
Company

## AICPA Threats vs. Yellow Book Threats

### AICPA

- Adverse Interest
- Advocacy
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence

### Yellow Book

- ~~Adverse Interest~~
- ~~Advocacy~~
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence
- Bias
- Structural

Cotton  
Company

# VISION 20/20

## AICPA Threats vs. Yellow Book Threats

### AICPA

- Adverse Interest
- Advocacy
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence

### Yellow Book

- ~~Adverse Interest~~
- ~~Advocacy~~
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence
- Bias
- Structural

Cotton  
Company

## Self-interest

The threat that a member could benefit, financially or otherwise, from an interest in, or relationship with, a client or persons associated with the client.

***Conflict of Interest?***

Cotton  
Company

## Journalists and Political Activism



**Political activism.** A commendable MSNBC.com investigation revealed that at least 140 journalists contributed to political parties, movements or candidates. Many journalists explained why they felt they had done nothing wrong and nothing contrary to their news organization's policies.

Ten Florida journalists accepted payment from the federal government in exchange for their contributions to television and radio stations that work to undermine Cuban President Fidel Castro's regime.

SPJ's ethics code states that journalists should "remain free of associations and activities that may compromise integrity or damage credibility." The code also encourages journalists to shun "... political involvement, public office and service in community organizations if they compromise journalistic integrity."

Cotton  
Company

How would these journalists measure up against  
OUR code of ethics?

Cotton  
Company

# VISION 20/20

## AICPA Threats vs. Yellow Book Threats

### AICPA

- Adverse Interest
- Advocacy
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence

### Yellow Book

- ~~Adverse Interest~~
- ~~Advocacy~~
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence
- Bias
- Structural

Cotton  
Company

## Journalists and Political Activism

 **Society of Professional Journalists**  
Improving and protecting journalism since 1909

**Political activism.** A commendable MSNBC.com investigation revealed that at least 140 journalists contributed to political parties, movements or candidates. Many journalists explained why they felt they had done nothing wrong and nothing contrary to their news organization's policies.

Ten Florida journalists accepted payment from the federal government in exchange for their contributions to television and radio stations that work to undermine Cuban President Fidel Castro's regime.

SPJ's ethics code states that journalists should "remain free of associations and activities that may compromise integrity or damage credibility." The code also encourages journalists to shun "... political involvement, public office and service in community organizations if they compromise journalistic integrity."

***Conflict of Interest?***

Cotton  
Company

## Journalist/Source Relationships



**Journalist/Source relationships.** Journalists must maintain a healthy distance from people they cover.

A former Telemundo anchorwoman reported about Los Angeles Mayor Antonio Villaraigosa's marital difficulties without mentioning that she was dating him. The station suspended and reassigned the anchor. When the anchor didn't show up for her new assignment, the station announced that she had quit her job.

Getting too close to sources sorely compromises a journalist's ability to "act independently," as SPJ's code instructs.

"Avoid conflicts of interest, real or perceived," the code states. And "remain free of associations and activities that may compromise integrity or damage credibility," the code instructs."

How would these journalists measure up against  
OUR code of ethics?



## AICPA Threats vs. Yellow Book Threats

### AICPA

- Adverse Interest
- Advocacy
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence

### Yellow Book

- ~~Adverse Interest~~
- ~~Advocacy~~
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence
- Bias
- Structural

Cotton  
Company

## Journalist/Source Relationships



**Journalist/Source relationships.** Journalists must maintain a healthy distance from people they cover.

A former Telemundo anchorwoman reported about Los Angeles Mayor Antonio Villaraigosa's marital difficulties without mentioning that she was dating him. The station suspended and reassigned the anchor. When the anchor didn't show up for her new assignment, the station announced that she had quit her job.

Getting too close to sources sorely compromises a journalist's ability to "act independently," as SPJ's code instructs.

"Avoid conflicts of interest, real or perceived," the code states. And "remain free of associations and activities that may compromise integrity or damage credibility," the code instructs."

***Conflict of Interest?***

Cotton  
Company

# VISION 20/20

## Feds Fault Premie Researchers For Ethical Lapses

npr

- Study involved 1,300 premature infants at nearly 2 dozen medical institutions between 2004 and 2009
- Infants were randomly assigned to receive 2 different levels of oxygen to see which was better at preventing blindness without increasing the risk of neurological damage or death
- Parents were not told in advance about the “reasonably foreseeable risks.”

Cotton  
Company

Source: <https://www.npr.org/sections/health-shots/2013/04/10/176811809/feds-fault-preemie-researchers-for-ethical-lapses>

## Feds Fault Premie Researchers For Ethical Lapses

npr

- In fact, the consent form “did not identify any risks” from subjecting the infants to either the high or low oxygen levels.
- The published study showed that the infants who got the higher oxygen level had more than twice the incidence of severe blindness; while infants who got the lower level were slightly more likely to die.

Cotton  
Company

Source: <https://www.npr.org/sections/health-shots/2013/04/10/176811809/feds-fault-preemie-researchers-for-ethical-lapses>

## Feds Fault Premie Researchers For Ethical Lapses

npr

- Among the 654 babies in the low-oxygen cohort, 130 died—3.2% more than in the high oxygen cohort.
- In the high-oxygen cohort, 91 of 509 developed blindness—a rate of nearly 18%, compared to 9% in the low-oxygen cohort.
- The flawed consent forms were approved by ethics committees at all 23 medical institutions involved in the study.

Cotton  
Company

Source: <https://www.npr.org/sections/health-shots/2013/04/10/176811809/feds-fault-preemie-researchers-for-ethical-lapses>

## Feds Fault Premie Researchers For Ethical Lapses

npr

- The ethical problem came to light when Public Citizen called on the HHS secretary to apologize to the parents of the 1,316 infants involved in the study.
- *The word 'unethical' doesn't even begin to describe the egregious and shocking deficiencies in the informed-consent process for this study," Dr. Michael Carome of Public Citizen's Health Research Group says in a press release. He says it's likely that many parents would not have agreed to enroll their infants in the study if they had known about the risks.*

Cotton  
Company

Source: <https://www.npr.org/sections/health-shots/2013/04/10/176811809/feds-fault-preemie-researchers-for-ethical-lapses>

# VISION 20/20



## Patient Recruitment Ethics in Clinical Research Ethical Guidelines

### Informed Consent

For research to be ethical ... individuals should make their own decision about whether they want to participate .... This is done through a process called informed consent in which individuals (1) are accurately informed of the purpose, methods, risks, benefits, and alternatives to the research, (2) understand this information and how it relates to their own clinical situation or interests, and (3) make a voluntary decision about whether to participate.

Cotton  
Company

How would these medical researchers measure up against OUR code of ethics?

Cotton  
Company

# VISION 20/20

## AICPA Threats vs. Yellow Book Threats

### AICPA

- Adverse Interest
- Advocacy
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence

### Yellow Book

- ~~Adverse Interest~~
- ~~Advocacy~~
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence
- Bias
- Structural

Cotton  
Company



### Patient Recruitment Ethics in Clinical Research Ethical Guidelines

#### Informed Consent

For research to be ethical ... individuals should make their own decision about whether they want to participate .... This is done through a process called informed consent in which individuals (1) are accurately informed of the purpose, methods, risks, benefits, and alternatives to the research, (2) understand this information and how it relates to their own clinical situation or interests, and (3) make a voluntary decision about whether to participate.

**Conflict of Interest?**

Cotton  
Company

# VISION 20/20

## Prosecutors



Mike Nifong

Cotton  
Company

<https://www.wral.com/news/local/video/1767541/>

Cotton  
Company

## Mike Nifong

- In 2006, prosecuted 3 Duke University lacrosse players for rape, sexual assault, and kidnapping
- Gave 50-70 media interviews in 1<sup>st</sup> weeks of the case; 48 statements to the press
- Nifong withheld DNA evidence from defense attorneys
- Many inconsistencies in the alleged victim's story surfaced
- NC Attorney General took over the case; dropped all charges against the 3 athletes.

 Cotton Company

## Mike Nifong

- NC State Bar filed ethics charges against Nifong
- Nifong disbarred based on guilty findings on 27 of 32 ethics charges
- Served 1 day in jail for contempt of court
- Civil suit by the 3 players revealed that Nifong thought the case would further his re-election efforts (Nifong told his campaign manager that the case would provide “millions of dollars in free advertising.”)
- Nifong declared bankruptcy in 2008 (\$244,000 in assets and \$180.3 million in liabilities)

 Cotton Company

# VISION 20/20



AMERICAN BAR ASSOCIATION  
Defending Liberty Pursuing Justice

CRIMINAL JUSTICE STANDARDS

for the

PROSECUTION FUNCTION

Nifong likely violated (at least) standards:

- 3-1.4 The Prosecutor's Heightened Duty of Candor
- 3-1.5 Preserving the Record
- 3-1.6 Improper Bias Prohibited
- 3-1.7 Conflicts of Interest
- 3-1.10 Relationship with the Media
- 3-3.3 Relationship with Courts, Defense Counsel and Others
- 3-5.4 Identification and Disclosure of Information and Evidence

Cotton  
Company

How would this prosecutor measure up against  
OUR code of ethics?

Cotton  
Company



# VISION 20/20

## AICPA Threats vs. Yellow Book Threats

### AICPA

- Adverse Interest
- Advocacy
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence

### Yellow Book

- ~~Adverse Interest~~
- ~~Advocacy~~
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence
- Bias
- Structural

Cotton  
Company

## Mike Nifong

- NC State Bar filed ethics charges against Nifong
- Nifong disbarred based on guilty findings on 27 of 32 ethics charges
- Served 1 day in jail for contempt of court
- Civil suit by the 3 players revealed that Nifong thought the case would further his re-election efforts (Nifong told his campaign manager that the case would provide “millions of dollars in free advertising.” **Conflict of Interest?**)
- Nifong declared bankruptcy in 2008 (\$244,000 in assets and \$180.3 million in liabilities)

Cotton  
Company

## *The Sad, Sad Case of Arthur Andersen*

Cotton  
Company

### The AICPA PEEC Issued the Conceptual Framework in 2006

- Arthur Andersen (the firm) “died” in 2002
- Could the Conceptual Framework have saved the firm?

Cotton  
Company

## Andersen: The Best of the Best

- Founded in 1914
- Motto: “Think Straight, Talk Straight”
- Changed the way auditing was done:
  - “[Andersen] made a name for himself by providing auditing that was answerable to companies’ shareholders, not their executives”



Source: Power Failure, The Inside Story of the Collapse of Enron, Mimi Swartz and Sherron Watkins, Doubleday, 2003, page 94.

## Andersen: The Best of the Best

*My own mother told me in Norwegian, “Think straight—talk straight.” No finer heritage could possibly be passed from one generation to another. It has been as a firm rock to which I could anchor in a storm. Never has it failed me.... This challenge will never fail anyone in a time of trial and temptation.*

*--Arthur E. Andersen*



Source: Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen, Barbara Ley Toffler, Broadway Books, 2003, page 9.

## Andersen: The Best of the Best

- At age 28, Arthur Andersen confronted the president of his fledgling firm's most lucrative client
- The company had not properly accounted for operating expenses, thereby inflating profits
- The president insisted that Andersen change his report
- Andersen said, "There's not enough money in the city of Chicago to induce me to change that report!"
- The client fired Andersen, "but, months later ... the [client] filed for bankruptcy. [Andersen] had been right."

Source: Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen, Barbara Ley Toffler, Broadway Books, 2003, page 12.



## Andersen: The Best of the Best

- Arthur Andersen died in 1947
- His successor was Leonard Spacek
- "It was under Spacek's leadership that the firm grew into the most respected—and feared—accounting firm in the world"
- "Leonard believed that you could be outspoken within the profession and develop a firm on integrity, and you would be respected by your clients for trying to move the profession forward" (according to Harvey Kapnick)

Source: Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen, Barbara Ley Toffler, Broadway Books, 2003, page 17-18.



## Andersen: The Best of the Best

- By the 1970s and 1980s, there were 8 major CPA firms, known as “The Big 8”
- In reality, however, there was Arthur Andersen, and then the other 7 firms
  
- How did things go so terribly wrong for Andersen?

 Cotton & Company

## How did things go so terribly wrong for Andersen?

- The auditing profession changed drastically in the 1990s
- “In the old days, the client didn’t tell us what to do. We told the client what was right. And if they didn’t listen to us, we dropped them. In those days, being dropped by your auditor was a scary business; it usually meant that your stock price would drop as well. Not anymore. Now if the auditor tells the client something it doesn’t like, the client drops the auditor—and that can mean a few million dollars a year right down the drain.” [Retired Andersen partner]

Source: Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen, Barbara Ley Toffler, Broadway Books, 2003, page 49.

 Cotton & Company

# VISION 20/20

## How did things go so terribly wrong for Andersen?

- The auditing profession changed drastically in the 1990s in another significant way—consulting
- The major CPA firms discovered that consulting services were higher profit and lower risk
- This relegated the audit to a commodity—an avenue to get access to lucrative consulting work—sometimes as a loss leader

 Cotton & Company

## How did things go so terribly wrong for Andersen?

- In the late 1970s, Andersen's CEO, Harvey Kapnick, foresaw the inherent conflict of interest in auditing and consulting at the same client and proposed splitting the two practices while remaining under the Andersen Worldwide (AW) organization
- This led to a two-decades-long struggle within the firm between AA (Arthur Andersen) and AC (Andersen Consulting)
- On 17 December 1997, the AC partners voted to break completely from AA

Source: Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen, Barbara Ley Toffler, Broadway Books, 2003, pages 77; 93.

 Cotton & Company

# VISION 20/20

## How did things go so terribly wrong for Andersen?

- Arbitration ensued to determine how much AC would pay AA; AA partners expected about \$15 billion
- In the meantime, to maintain profitability, AA immediately began ... selling consulting services
- AC offered AA \$2 billion; AA turned that down
- On 7 August 2000, the arbitrator ruled: AC had to pay AA \$1 billion; and AC could no longer use the Andersen name

Cotton  
Company

Source: Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen, Barbara Ley Toffler, Broadway Books, 2003, pages 96-97.

## How did things go so terribly wrong for Andersen?

- AC had been generating the majority of AW profits
- Loss of those profits when AC split in 1997 “meant an instant \$100,000 haircut per year for all AA partners”
- AA partners began selling ... consulting services
- The AA “one firm” culture changed drastically
- “In the end, it was all about the bucks”

Cotton  
Company

Source: Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen, Barbara Ley Toffler, Broadway Books, 2003, pages 98.

# VISION 20/20

## How did things go so terribly wrong for Andersen?

- “The four cornerstones of success at [AA]—People Management, Quality, Thought Leadership, and Financial Performance—were referred to as ‘three pebbles and a boulder.’ The boulder was financial performance. The rest, it seemed was a joke.”



Source: Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen, Barbara Ley Toffler, Broadway Books, 2003, pages 105.

## How did things go so terribly wrong for Andersen?

- In the late 1990s, Enron became the 7<sup>th</sup> largest corporation in the world
- Enron’s accounting involved “aggressive” creation and use of special purpose entities (SPEs) to hide liabilities and losses
- The AA partner in charge of the Enron engagement, David Duncan, was asked to approve each SPE
- Carl Bass, a member of AA’s Professional Standards Group pushed back on the SPE accounting



Source: Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen, Barbara Ley Toffler, Broadway Books, 2003, pages 210-213.



# VISION 20/20

## How did things go so terribly wrong for Andersen?

- Duncan and other senior partners overruled Bass and Enron demanded that Bass no longer be involved in the engagement
- In 2000, AA was earning \$52 million per year from the Enron—roughly half audit fees and half consulting fees
- On 16 October 2001, Enron reported 3<sup>rd</sup> quarter losses of \$638 million



Source: Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen, Barbara Ley Toffler, Broadway Books, 2003, pages 210-213.

## How did things go so terribly wrong for Andersen?

- AA in-house lawyer sent Duncan's team an email on 12 October 2001: "It might be useful to consider reminding the engagement team of our documentation and retention policy"
- Duncan interpreted that as a recommendation to begin shredding documents
- Enron filed for bankruptcy protection on 2 December 2001
- AA was indicted on one felony count of obstruction of justice on 14 March 2002



Source: Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen, Barbara Ley Toffler, Broadway Books, 2003, pages 219.

# VISION 20/20

## How did things go so terribly wrong for Andersen?

- On 15 June 2002, the jury returned a guilty verdict
- “For all intents and purposes, Andersen was dead”

Cotton  
Company

Source: Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen, Barbara Ley Toffler, Broadway Books, 2003, pages 219-220.

## The New York Times

### *Justices Unanimously Overturn Conviction of Arthur Andersen*

By LINDA GREENHOUSE MAY 31, 2005

WASHINGTON, May 31 - With a brief, pointed and unanimous opinion, the Supreme Court on Tuesday overturned Arthur Andersen's conviction for shredding Enron accounting documents as that company was collapsing in one of the nation's biggest corporate scandals.

The court held that the trial judge's instructions to the jury failed to require the necessary proof that Andersen knew its actions were wrong.

But the decision represents little more than a Pyrrhic victory for Andersen, which lost its clients after being indicted on obstruction of justice charges and has no chance of returning as a viable enterprise. The accounting firm has shrunk from 28,000 employees in the United States to a skeleton crew of 200, who are attending to the final details of closing down the partnership. [Page C1.] In its ruling, legal experts said, the Supreme Court did not ultimately settle the issue of whether Andersen acted with criminal intent when it allowed many of Enron's accounting papers to be destroyed. But it made clear that prosecutors went too far by pressing District Judge Melinda Harmon in Houston to set such a low hurdle for the jury to reach a guilty verdict in the case in 2002.

Cotton  
Company

# VISION 20/20

## Could the Conceptual Framework have saved Arthur Andersen?

- Adverse Interest
- Advocacy
- Familiarity
- Management Participation
- Self-Interest
- Self-Review
- Undue Influence

 Cotton Company

## End Thoughts

- Our ethics rules are complex (182 pages)
- It is difficult (if not impossible) to have a complete understanding of all of them
- *MOST* of the ethical problems we may encounter simply boil down to **conflicts of interest** (actual or in appearance)
- Remain alert for COIs
- Then, follow the Threats & Safeguards process
- Given the nature of COI situations, it's always helpful to seek advice from someone outside the COI situation—i.e., someone objective

 Cotton Company

# VISION 20/20

## Recommended Reading

- Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen, by Barbara Ley Toffler, Broadway Books, 2003
- Power Failure: The Inside Story of the Collapse of Enron, by Mimi Swartz and Sherron Watkins, Doubleday, 2003.
- Unaccountable: How the Accounting Profession Forfeited a Public Trust, by Mike Brewster, John Wiley & Sons, 2003.
- Enron: The Rise and Fall, by Loren Fox, John Wiley & Sons, 2003.
- CPAs (and I'm One) Can Reverse Their Losses, by Dave Cotton, The Washington Post, January 27, 2002.
- Fixing CPA Ethics Can Be an Inside Job, by Dave Cotton, The Washington Post, October 20, 2002.

Cotton &  
Company



## *Ethical Traps: Let's Examine Some Recent Real World Cases*

Dave Cotton, CPA, CFE, CGFM

Cotton &  
Company

635 Slaters Lane | Alexandria, VA 22314  
Main: (703) 836-6701 | Fax: (703) 836-0941