# streetwise

BY STEPHEN BARLAS, DREW MILLER, DAWN SMITH, CURT VERSCHOOR, KATHY WILLIAMS

[NEWS]

## SEC Chooses William McDonough to Head PCAOB

Kathy Williams, Editor

**THE SECURITIES & EXCHANGE COMMISSION LAST MONTH UNANIMOUSLY** selected William J. McDonough, president of the Federal Reserve Bank of New York, as chairman of the Public Company Accounting Oversight Board (PCAOB). The Board was created last year under provisions of the Sarbanes-Oxley Act of 2002.

McDonough, 69, has served as president since July 1993. He had joined the New York Fed in January 1992 as executive vice president and head of its financial markets group, which includes domestic open market and foreign exchange operations and U.S. government securities market surveillance.

Before coming to the New York Fed, he had a 22-year career with First Chicago Corp. and its bank, First National Bank of Chicago, retiring in 1989. After leaving First Chicago, McDonough served in a variety of executive roles, including adviser to the World Bank and International Finance Corporation, special adviser to the president of the Inter-American Development Bank, and chairman of the Illinois Commission on the Future of Public Service. He also was with the State Department from 1961 to 1967 and the U.S. Navy from 1956 to 1961.

At the press conference announcing his nomination, McDonough said, "The task before us is to restore the confidence of the American people and others around the world that the accounting statements issued by public companies registered in our country and certified by public accounting firms present a complete, true, and timely report that can be relied on. Confidence in the accuracy of accounting statements is the bedrock of investors being willing to invest, in lenders to lend, and for employees knowing that their firm's obligations to them can be trusted." And he added, "I see the job of the PCAOB as providing guidance in a constructive manner and, when necessary, to be a tough overseer to protect the public's interests and assure that any inappropriate behavior is ended."

The SEC will complete a thorough background investigation before the formal appointment.

### Sarbanes-Oxley Changes Some Corporate Practices

Eighty-four percent of senior executives polled in the latest PricewaterhouseCoopers Management Barometer survey say that the Sarbanes-Oxley Act has changed control and compliances practices in their companies. Just 4%, though, cite significant changes and 27%, modest change, while 53% say the new law simply formalizes what their company has already been doing. Eighty-two percent are

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### E-COMMERCE SECURITY

A new book published by the Information Systems Audit and Control Foundation® (ISACF®) identifies key security risks and best-practice countermeasures for corporate networks. Titled *e-Commerce Security: Securing the Network Perimeter*, it covers design concepts and components of a network security system in depth and offers practical advice on setting up a proper system. It also has an internal audit questionnaire, a perimeter security audit program, a list of information sources, and a glossary, among other useful tools.

For pricing information, contact the Information Systems Audit and Control Association at (847) 253-1545, ext. 401, or e-mail bookstore@isaca.org. ■

OVER 80% OF OCCUPATIONAL FRAUDS INVOLVE ASSET MISAPPROPRIATION. CASH WAS THE TARGETED

## READERS' INPUT

REFRESHING ARTICLE

I thoroughly enjoyed David Harrison's article, "Business Valuation Made Simple" [Feb. 2003]. It's quite refreshing to see output (especially from an academician) that is an efficient use of words and does not reach for lofty diction that is sure to impress those underprivileged of vocabulary. His message is simple, thorough, to the point, and will benefit the underprivileged and privileged alike.

By about "Get an Appraisal?" I found myself shaking my head that [his] article was actually published, although *Strategic Finance* is certainly much more down to earth than many other publications. Once I got to "Back to the Basics: Cash!", I found myself wondering how much wealth [he has] brought to [his] students....How much more rich our educations would be if educators could be a little less lofty and theoretical and could bridge the theoretical and real worlds for students, just a *little* more. Perhaps the demands we place on our educators do not give them that luxury. I hope that [his] worth is recognized in a world where so few provide that bridge for those around them.

*Dawn A. Smith, controller*
*Power Monitors, Inc.*

[ETHICS]

# New Evidence of Benefits from Effective Ethics Systems

by Curtis C. Verschoor, CMA, Editor

**TWO NEW FRAUD STUDIES PROVIDE MORE EVIDENCE THAT ORGANIZATIONAL** commitment to a code of conduct that stresses open communications and concern for ethical behavior really does pay off. In today's post-Enron focus on effective governance, management accountants and financial managers should emphasize actions promoting ethical behavior that can preserve assets and thus improve profits.

Periodically, the Association of Certified Fraud Examiners surveys its members to ascertain the nature and extent of occupational fraud and abuse in the United States. Their latest survey, *2002 Report to the Nation: Occupational Fraud and Abuse*, contains some startling results:

- Certified fraud examiners estimated that 2002 frauds cost some 6% of revenue, which projects to $600 billion in total and averages $4,500 per employee.
- Over 80% of occupational frauds involve asset misappropriation. Cash was the targeted asset 90% of the time, and the average scheme lasted 18 months.
- The most common detection method was a tip from an employee.
- Organizations with hotlines cut their fraud losses per scheme by about 50%.
- Smaller businesses are the most vulnerable to occupational fraud and abuse. The average reported loss per scheme was nearly 25% larger than that experienced by the largest companies.[1]

Asset misappropriations, including skimming revenues, stealing inventory, payroll fraud, and fraudulent vendor disbursements, were the most numerous. The other fraud methods were corruption, including conflicts of interest such as accepting kickbacks, and fraudulent financial statements. Although less frequent, the latter two types of fraud resulted in larger losses—per scheme and in total.

The importance of employee tips to detecting fraud highlights another benefit of an open corporate culture and receptive channels of upward communication. Open communication is usually associated with effective operation of an ethics system. Together with tips from vendors, customers, and anonymous sources, information from individuals resulted in the discovery of almost half the fraud schemes. Since the average fraud scheme lasted 18 months, more effective detection would have cut the average loss.

In terms of fraud prevention, the most helpful measure was shown to be strong internal controls. Ethics training for employees and anonymous fraud reporting mechanisms were mentioned in the survey, but less frequently. Analysis of factors that cause fraud indicated that insufficient controls were responsible in 46.2% of the cases, and ignoring existing controls were responsible in 39.9%.

Another study, *Fraud: The Unmanaged Risk*, global in scope, has been released by Ernst & Young.[2] As this was a survey of "publicly reported" frauds, the study correctly viewed its findings as only the tip of the iceberg (said to be 20% of the total). Like the ACFE report, the E&Y study concludes that internal controls are the most likely factor to both prevent and detect fraud. The next most likely factors

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[GOVERNMENT]

# FASB Under Congressional Lens | Stephen Barlas, Editor

**BOB HERZ, THE FINANCIAL** Accounting Standards Board chairman, came up to Capitol Hill on March 4 and faced a notably less friendly atmosphere than preceding chairmen faced when appearing before congressional committees. Congressmen no longer sit in FASB hearings with their minds a million miles away after having spent a few minutes at the start of the hearing trying, unsuccessfully, to comprehend complex accounting testimony. Legislators in the House Commerce subcommittee on commerce, trade, and consumer protection were all ears as Herz explained the FASB's January 2003 rule on special-purpose entities (SPEs). The FASB standard requires companies with investments in or relationships with special-purpose entities (SPEs) to carefully assess their involvement to determine whether they receive a majority of the risks or rewards of those SPEs. If they do, they have to report the assets, liabilities, and gains and losses of those SPEs within their own financial statements. Even Republican subcommittee Chairman Rep. Cliff Stearns (R.-Fla.), who had a lot of positive things to say about constructive changes the FASB has made recently, voiced some skepticism over the effectiveness of the new SPE rule.

Reflective of the new political environment the FASB faces was the formation the day before the hearings of a new SEC watchdog group by Ralph Nader called the Association for Integrity in Accounting. One of its first priorities, apparently, is getting rid of the FASB.

## Collect Corporate Penalties

Those in the corporate world who let out a sigh of relief and thought last year's Sarbanes-Oxley bill (S-O)

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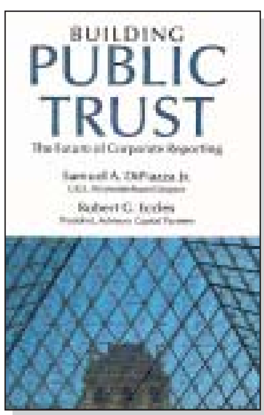
BOOKS

# Creating Trust in Corporate Reporting

✷ **IN THE BOOK, *BUILDING PUBLIC TRUST: THE*** *Future of Corporate Reporting*, Samuel A. DiPiazza, Jr., and Robert G. Eccles offer their recommendations on how to deal with the crises and scandals that have rocked Wall Street. The title is very timely, but not entirely accurate. While the book does provide a good overview of major accounting and corporate reporting issue, it fails to adequately deal with the key question on investor's minds today: trust. The authors outline a convincing case for their new system of expanded information reporting but fail to offer proposals for ensuring that the companies and corporate auditors don't lie in reporting or how the new reporting works to build more trust.




What they propose is a "Three-Tier Model of Corporate Transparency" for corporate reporting that would include:

1. Using a set of global GAAP;
2. Industry-based standards—information relevant and key to evaluating specific industries, applied consistently in a standard method; and
3. Company-specific information—guidelines for reporting on strategy and plans, risk management, compensation policies, and performance measures unique to the company.

Utilizing these concepts, the idea is to provide a "holistic view of the enterprise—its marketplace opportunities, its strategies and their implementation, its value drivers,

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[GOV'T] *cont'd from p. 3*

was the end of congressional efforts to legislate the lessons of Enron, et al., need to think again. Stephen Cutler, the director of the division of enforcement at the SEC, laid out a long shopping list of S-O add-ons he wants when he testified before the House Financial Services Committee in February. One of Cutler's primary objectives is to get additional authority to collect both corporate and corporate executive personal funds with which to compensate defrauded investors. S-O created something called the Fair Fund, which provides compensation to investors with civil penalties obtained from companies by the SEC. But the problem is the S-O provision says the SEC can only distribute civil penalties it collects from defendants who were ordered to pay disgorgements. Cutler wants that changed so penalties paid by defendants who didn't pay disgorgements could also flow into the Fair Fund. He also wants Congress to fix the situation where former executives of bankrupt corporations can use state law homestead exemptions and other protections to shield their assets from collection.

## Baptism Under Fire

Letters from disgruntled senators began arriving in new SEC Chairman William Donaldson's inbox two weeks after he got behind his desk. Donaldson may have thought that since predecessor Harvey Pitt had taken care of the issue of limiting the provision of tax services by auditors, that fire had been extinguished. Wrong! On March 4, Senators Charles Grassley (R.-Iowa) and Max Baucus (D.-Mont.), the chairman and ranking member of the Finance Committee, urged Donaldson to revisit that very controversial issue. They pointed to a February report produced by the Joint Committee on Taxation (JCT) relating to the collapse of Enron. The JCT report, titled "Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations," provides a detailed analysis of Enron's complex tax transactions and the role played by promoters and advisers. The letter contained these pregnant sentences: "In particular, we would appreciate the benefit of your views on the use of complex tax-motivated transactions designed to avoid taxes and attain financial statement benefits. We are also interested in your views on the extent to which the SEC's January 22, 2003, decision to allow accounting firms to provide tax consulting services to their audit clients will help prevent future Enrons, or whether that decision should be modified in light of the JCT's report." ■

[ETHICS] *cont'd from p. 2*

are "whistle-blowers" and internal audit. For prevention, they are management review and internal audit.

The E&Y survey showed a significant increase in the number of organizations that had codified guidelines on dealing with ethical and fraud-related behaviors since their last study. Fifty percent of the organizations now have some method of handling ethical or fraud-related activities, such as a code of conduct, a governance code, a response plan, or specific anti-fraud policies. In spite of this, the E&Y study quotes a report from a U.K. auditing body: "The development of a corporate anti-fraud culture requires serious and sustained training." Yet it reported little progress had been made on this front since a 1999 report outlining "serious deficiencies in the programmes run by business, educational institutions, and the professions." These comments illustrate the benefits of ethics and fraud training and reinforce their importance.

In another North American survey, one in five employees stated that they were personally aware of people stealing from their employer. Management had no idea this was going on. The E&Y response was that "Perhaps whistleblowing channels could close the gap between the perceptions of staff and management."

We continue to believe that the publication of a code of conduct is only the first step in achieving the benefits of an open corporate culture. Vitally important is its administration—day-to-day management emphasis, training, compliance/audit, and integration into the reward structure.

Management accountants and financial managers can be very helpful in achieving these objectives. ■

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1 The report is available at the ACFE website: marketplace.cfenet.com/pdfs/2002RttN.pdf.

2 The report is available at the Ernst & Young website: http://www.ey.com/global/download.nsf/Canada/Fraud_The_Unmanaged_Risk_Survey_2003/$file/Fraud_The%20Unmanaged%20Risk_Survey_2003.pdf.

**[BOOKS]** *cont'd from p. 3*
and its financial outcomes." All three tiers are designed to simplify the reporting process, making it easier for stockholders, stakeholders, investors, and anyone else who needs the information to read and interpret the information provided. With a clearer idea of an organization's economic picture, they can then make better-informed decisions.

DiPiazza and Eccles also give useful insight into the problems with GAAP and the evolution and likely future of achieving a global standard in accounting principles and reporting standards. Their chapter on industry standards and pro forma reporting is a good overview of key issues, such as sustainability reporting and the latest developments in SEC guidelines on corporate reporting. They also give examples of companies that are providing more and better information and some helpful websites.

DiPiazza is the CEO of PricewaterhouseCoopers, and Eccles is a senior fellow. Consequently, their book has all the "it's not the accountant's fault" bias you would expect. There are no new solutions to combat fraud, just the standard and unhelpful admonition that "investors must bear the ultimate responsibility for obtaining, understanding, and analyzing the information they use." They don't address what to do if the information is false/manipulated. Rather than focusing on how to build trust, the book shows how to report more information.

A *Wall Street Journal* ad for the book hypes, "It's time for less rhetoric about trust and more substance." I agree, but this book offers no substantive answers for improving public trust. Readers hoping to find concrete answers for how to prevent future Enron/WorldCom debacles and restore investor trust in corporate reports will have to find another book.—*Drew Miller*

**[NEWS]** *cont'd from p. 1*
confident their company is in full compliance, while 13% say they have more to do.

Do they believe the new rules will help restore investor confidence? Thirty-one percent said, yes, while 50% said it would have no impact, and 19% weren't sure.

For complete survey results, visit www.barometersurveys.com. ■