streetwise

BY STEPHEN BARLAS, PAUL SHILLAM, CHARLES WERNER, KATHY WILLIAMS

[NEWS]

Are Companies More Ethical Now? | KATHY WILLIAMS

It depends. Nearly three out of four employees responding to KPMG's 2005-2006 Integrity Survey reported that they had observed misconduct at their companies in the previous 12 months, and half said that what they observed was serious and could cause "a significant loss of public trust if discovered."

On the other hand, they said that the conditions that help management prevent, detect, and respond to fraud and misconduct are improving. And employees who work in companies with comprehensive ethics and compliance programs reported that they saw fewer instances of misconduct and that they had a higher level of confidence in management's integrity.

The categories of fraud and misconduct that were assessed in the survey are compromising customer or marketplace trust, shareholder or organizational trust, employee trust, supplier trust, public or community trust, and general, such as violating company values and principles. The survey results listed several excellent examples under each category, such as engaging in false or deceptive sales practices, falsifying or manipulating financial reporting information, violating workplace health and safety rules, paying suppliers without accurate invoices or records, making improper payments or bribes to foreign officials, or doing business with third parties prohibited under international trade restrictions and embargoes.

Which industries experienced the highest prevalence of misconduct? They are the public sector; global manufacturers; energy and chemicals; electronics, software, and services; healthcare; food, retail, and distribution; and communications and media. And to whom would employees report misconduct? Eighty-one percent said they would notify their supervisor or another manager, 53% said they would try to solve the matter directly, and 38% said they would call an ethics or compliance hotline. Only 6% said they would look the other way or do nothing.

There also are a comparison of the 2000 and 2005 survey results and an overview of various rules and regulations, such as the Sarbanes-Oxley Act (SOX). Results are based on responses from more than 4,000 U.S. employees in 16 job functions from 11 industry sectors. To download a free copy of the entire report, visit www.us.kpmg.com and click on "KPMG's 2005-2006 Integrity Survey."

IFAC WANTS COMMENTS ON ETHICS PROPOSAL

As mentioned in this column last month, the International Accounting Education Standards Board (IAESB), an independent standards-setting board within the International Federation of Accountants (IFAC), is proposing new guidance to help professional accountants make ethical decisions. The exposure draft of the new International Education Practice Statement (IEPS), "Approaches to Developing and Maintaining Professional Values, Ethics and Attitudes," is now available for preview and comment. The Statement is designed to help IFAC member bodies develop ethics education and continuing professional development programs for their members.

Comments on the exposure draft should be submitted by December 15, 2006. You can download the publication by going to www.ifac.org/EDs. Scroll down until you see the title of the document listed under the heading International Accounting Education Standards Board, and click on it. If you want to e-mail your comments, the address is edcomments@ifac.org. ■

Letters to the Editor

COSO Framework

Parveen Gupta and Jeff Thomson's article [September] was excellent.

When I was Chief Technical Officer of Grant Thornton, we adopted an audit approach that emphasized substantive testing for two reasons: (1) We were convinced that even good internal controls would not prevent management fraud, and (2) for much of the firm's client base it was simply more efficient to take a substantive approach. In the years that followed we stopped lots of fraudulent situations. And by the time I left for academe in 1982, we were the last of the large firms never to have been disciplined by the SEC. In short, substantive testing as an audit emphasis works.

Today, as I continue to work as a malpractice expert in fraud cases, I am more convinced than ever that a substantive testing reemphasis would be a good thing. Unfortunately, as a direct result of Sarbanes-Oxley, we are on a track that emphasizes internal controls. Does anyone really believe that internal controls will stop fraud by people like Ebbers, Skilling, Lay, and Kozlowski? What will stop it is good, substantive auditing and tough application of Section 10A of the 1934 Act by the outside auditors.

Finally, if we must persist in spending our time on controls, of course the COSO framework should be fixed and updated. However, I believe our time would be better spent amplifying our substantive testing with such techniques as modern data mining.

Charles A. Werner, JD, CPA

[GOVERNMENT]

Next on Executive Compensation?

STEPHEN BARLAS, EDITOR

Now that the Securities & Exchange Commission (SEC) has finished its rule making for mandating new disclosures about compensation for top corporate officers, some are looking for the Commission to take a next step. The most likely possibility is a rule that would allow an advisory shareholder vote on certain aspects of executive compensation. The U.K. and Australia already allow that. The SEC got some comments on the idea even though it wasn't proposed as part of the executive compensation rule. When that rule was finalized at the end of July, Roel Campos, one of the commissioners, said the Commission didn't have the time to consider the notion because it wanted to get the executive compensation release out well in advance of proxy season. But he kicked the door wide open, adding, "However, I think this is an important idea that may promote transparency, and it deserves to be fully explored in future iterations of our executive compensation rules. Perhaps we will receive more thoughts from commenters about this idea in the future."

The executive compensation disclosure rules set out numerous requirements. The two headline provisions require companies to disclose a "total" compensation figure for the principal executive officer, principal financial officer, the three other highest-paid executive officers, and the directors. The compensation number would include the fair value of options and stock issued to executive officers. Second, companies are required to have meaningful narrative disclosure about compensation practices in a new financial report section titled "Compensation Discussion and Analysis," or CD&A.

Capitol Hill Considering Next Steps on Compensation

While the new SEC executive compensation reporting rules will make it easier to understand what CEO stock options are worth, those rules won't dampen the more general furor over CEO compensation. SEC Chairman Chris Cox believes that the reason nonsalary corporate pay has gone through the roof is the 1993 law, which he supported when he was in Congress, that allows companies to deduct pay for top corporate officers when that pay is over $1 million a year—but only if that overage is performance based. Companies started using stock options to a much greater extent in 1993 because they were seen as performance-based pay. "I well remember that the stated purpose was to control the rate of growth in CEO pay," Cox wrote in a letter to the Senate Finance Committee, which held hearings on stock options on September 6. "With complete hindsight, we can now all agree that this purpose was not achieved. Indeed, this tax law change deserves pride of place in the Museum of Unintended Consequences."

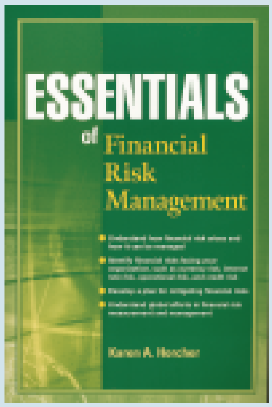
At those hearings, both the Committee's Republican chairman and its top Democrat used moral and ethical allusions to describe the current objectionable state of high executive pay. Sen. Chuck Grassley (R.-Iowa) said CEO

[BOOKS]

An Overview of Financial Risk Management

In *Essentials of Financial Risk Management*, author Karen A. Horcher defines financial risk management as "a process to deal with the uncertainties resulting from financial markets." Horcher summarizes the process of financial risk management as:

- "Identify and prioritize key financial risks.
- Determine an appropriate level of risk tolerance.
- Implement risk management strategy in accordance with policy.
- Measure, report, monitor, and refine as needed."



Horcher methodically addresses the various topics that fall under the umbrella of financial markets, including interest rate risks, foreign exchange risk, credit risk, commodity risk, and operational risk. Her book isn't intended to be a technical treatise; rather, it's a high-level overview of the various financial risk areas designed to provide a fundamental framework of understanding.

Two chapters that I found particularly interesting covered operational risk and the policy and hedging of the risk management framework. In the chapter on operational risk, Horcher takes the topics from prior chapters and describes how they fit into the overall financial processes. For example, she discusses internal control, cash management, conflicts of interests, and management oversight. It's important to use these tools to monitor not only the process of financial risk management but its effectiveness as well. Establishing appropriate checks and controls that report on activity compared to plans and market helps to provide feedback on whether the financial tools are meeting the organization's objectives.

The next chapter, addressing the risk management framework, emphasizes the importance of establishing a risk management policy at the level of the board of directors. Horcher discusses the importance of the board overseeing the policies and strategies used to mitigate risks.

As I read this book, I also appreciated the insightful "Tips & Techniques," which helped clarify the points discussed in the main text. Horcher also includes case examples in vignettes called "In the Real World" that illustrate her key points. She concludes the book with an appendix of additional resources, which the reader can use to find additional information on various topics.

After finishing this book, I have a greater appreciation and a better understanding of the complexities of financial risk management. The book achieves its objective of fostering "an understanding of the risks and methods often used to manage those risks."

Essentials of Financial Risk Management is part of the Essentials series published by John Wiley & Sons, Inc. This series is designed to provide resources for professionals to "quickly acquire knowledge and skills in core business areas." *Essentials of Financial Risk Management* does just that, providing a quick-paced introduction to the highly complex area of financial risk management.—*Paul Shillam*

salaries violate the "concept of an honest day's work for an honest day's pay in our free market economy." He added, "When anyone threatens our fundamental principles, we must take it very seriously or risk losing our greatness as a nation." These kinds of apocalyptic statements are generally reserved for this country's enemies, not its corporate leaders. But Grassley's complaint demonstrates how deep the ill will runs in regard to corporate pay practices.

Two things are likely to happen in the near future. First, look for Congress to pass legislation in 2007 that either ends or severely curtails the 1993 deduction. Second, the SEC office of the chief accountant will soon issue further public guidance on the accounting issues surrounding backdating of stock options, meant to help companies navigate the ins and outs of the new executive compensation reporting rules. ■