

Memorandum

ECC Agenda Item VI.
January 26, 2011

To : ECC Members

Date : December 20, 2010

Telephone : (916) 561-4310

Facsimile : (916) 263-3676

E-mail : dfranzella@cba.ca.gov

From : Dominic Franzella, Manager
License Renewal & Continuing Competency Unit

Subject : Ethics Study Required by Business and Professions Code Section 5093

This memorandum is being provided to supply information to Ethics Curriculum Committee (ECC) members on the following topics:

1. Further Background Regarding Senate Bill (SB) 819
2. Impact of Recommending Less Than 10 Units of Ethics Study
3. Next Steps in Recommending Ethics Study Guidelines to the California Board of Accountancy (CBA)

Further Background Regarding SB 819

At the request of ECC Chair Donald Driftmier, CPA, in early December, staff sent letters (**Attachment #1**) to the California Society of Certified Public Accountants (CalCPA) and Center for Public Interest Law (CPIL) requesting further background on SB 819. Specifically, staff posed the following two questions:

1. How did the Legislature come to specify the total number of units of ethics study at a minimum of 10, as opposed to setting it at a lower or higher number?
2. What discussions occurred regarding the number of possible courses available to meet the requirement?

Provided in **Attachments #2 and #3** respectively are the responses received from CPIL and CalCPA. After receiving CPIL's letter (dated December 15, 2010), Mr. Howard requested that three news articles be included as part of his letter to further underpin his remarks.

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Impact of Recommending Less Than 10 Units of Ethics Study

At the September 21, 2010 ECC meeting considerable discussion occurred regarding the directive the CBA placed on the ECC requiring the committee to determine the appropriateness and feasibility for obtaining 10 units of ethics study. Various members noted that the law as presently written does not allow for anything less than a minimum of 10 units to be recommended to the CBA. ECC Chair Donald Driftmier, CPA, requested that staff provide information on the impact should the ECC recommend to the CBA anything less than 10 units of ethics study.

Business and Professions Code Section 5094.6(a) states, “the [ECC] shall recommend to the [CBA] ethics study guidelines consisting of no less than 10 semester units to be included as part of the education required under Section 5093.” As some members clearly noted at the prior meeting, the language in present law offers no latitude for the ECC to provide the CBA anything less than 10 units; however, it does not prohibit the ECC, should it believe necessary, to recommend to the CBA more than 10 units. Therefore, any recommendation that comes in at less than 10 units would require a legislative change.

Next Steps in Recommending Ethics Study Guidelines to the CBA

The materials provided for this meeting have supplied members with increased information on SB 819, applicants applying for California CPA licensure, where ethics is presently available at various California colleges and universities, and where new practitioners could benefit from with increased ethics. In addition, SB 819 provides the following definition for the ethics study guidelines:

[A] program of learning that provides students with a framework of ethical reasoning, professional values, and attitudes for exercising professional skepticism and other behavior that is in the best interest of the investing and consuming public and the profession. At a minimum this includes academic work or independent study and shall include a foundation for ethical reasoning and the core values of integrity, objectivity, and independence consistent with the International Education Standards-4 of the International Accountants Education Standards Board, the International Federation of Accountants Code of Ethics, and the American Institute of Certified Public Accountants Code of Professional Conduct.¹

For future meetings staff believe it is important to identify those topics and issues members wish to discuss that will begin establishing a framework for the ethics study. Topics may include:

- Further discussion regarding ethics embedded in various accounting and business courses. As evidenced by the research conducted and provided by

¹ These materials are included in the ECC Reference Materials provided at the September 21, 2010 meeting.

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ECC members, courses exist where ethics is not part of the course title but embedded in the course materials being covered. Does the ECC wish to allow for portions of courses to count towards the 10 units of ethics study? If so, what factors would go into determining how many units of a course could qualify? How would staff know to apply a portion of a course towards ethics-based study on a single title on a transcript?

- Should the ECC prescribe a specified number of units in a specific area of ethics study (e.g. business ethics, personal ethics, or philosophy of ethics)?
- Should some portion of ethics study be completed at an upper division level?

The above list represents some initial topics/issues that could be addressed at future ECC meetings. It is not an exhaustive list, but is being provided to facilitate discussion. Staff would greatly value any additional topics/issues that members believe important as the committee continues discussions on the ethics study guidelines.

Attachments



DEPARTMENT OF CONSUMER AFFAIRS
CALIFORNIA BOARD OF ACCOUNTANCY
2000 EVERGREEN STREET, SUITE 250
SACRAMENTO, CA 95815-3832
TELEPHONE: (916) 263-3680
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WEB ADDRESS: <http://www.cba.ca.gov>



November 30, 2010

Attachment #1

Bruce Allen
California Society of CPAs
1201 K Street, Suite 1000
Sacramento, CA 95814

Dear Mr. Allen:

The Ethics Curriculum Committee (ECC), tasked with supplying guidelines to the California Board of Accountancy (CBA) on the 10 units of ethics study required as a result of Senate Bill (SB) 819, held its first meeting on September 21, 2010. At this meeting, CBA staff provided ECC members with an overview of licensure requirements and SB 819.

As the ECC continues toward developing the ethics study guidelines, CBA staff would like to provide ECC members with additional background on how the Legislature came to the decision to require the 10 units of ethics study. As the California Society of CPAs and the Center for Public Interest Law were instrumental in working with the Legislature in developing the language affecting the CBA in SB 819, we are requesting that each organization provide information on the questions outlined below.

- How did the Legislature come to specify the total number of units of ethics study at minimum of 10, as opposed to setting it at lower or higher number?
- What discussions occurred regarding the number of possible courses available to meet the requirement?

As the next ECC meeting is scheduled for January 26, 2011 in Irvine, California, CBA staff would appreciate responses to these questions by December 15, 2010. If you would prefer, CBA staff is open to having a conference call regarding the above questions. Should you wish to discuss the questions via a conference call, please contact Cindi Fuller, Licensing Coordinator, by telephone at (916) 561-4367 or by e-mail at cfuller@cba.ca.gov.

As an important stakeholder, we value your input and look forward to working with you. Should you have any questions, please do not hesitate to contact Ms. Fuller at the contact information above, or Dominic Franzella, Licensing Manager, by telephone at (916) 561-4310 or by e-mail at df Franzella@cba.ca.gov.

Sincerely,

Patti Bowers, Executive Officer
California Board of Accountancy

c: Donald Driftmier, CPA, ECC Chair
ECC Members
Jeannie Tindel, CalCPA
Julianne D'Angelo Fellmeth, CPIL
Ed Howard, CPIL



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November 30, 2010

Julianne D'Angelo Fellmeth, CPIL Administrative Director
Center for Public Interest Law
University of San Diego School of Law
5998 Alcalá Park
San Diego, CA 92110

Dear Ms. Fellmeth:

The Ethics Curriculum Committee (ECC), tasked with supplying guidelines to the California Board of Accountancy (CBA) on the 10 units of ethics study required as a result of Senate Bill (SB) 819, held its first meeting on September 21, 2010. At this meeting, CBA staff provided ECC members with an overview of licensure requirements and SB 819.

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Sincerely,

Patti Bowers, Executive Officer
California Board of Accountancy

c: Donald Driftmier, CPA, ECC Chair
ECC Members
Ed Howard, CPIL
Bruce Allen, CalCPA
Jeannie Tindel, CalCPA

Attachment #2



December 15, 2010

Patti Bowers, Executive Officer
California Board of Accountancy
2000 Evergreen Street, Suite 250
Sacramento, California 95815-3832

Dear Ms. Bowers:

You have written asking certain questions of CPIL about the required ten units of ethics education.

CPIL is a nonprofit, nonpartisan academic and advocacy organization based at the University of San Diego School of Law. For twenty-seven years, CPIL has studied occupational licensing and monitored California agencies that regulate businesses, trades, and professions, including the California Board of Accountancy. To our knowledge, no other consumer group in the nation monitors the accounting profession on an ongoing basis.

CPIL's expertise has long been relied upon by the Legislature, the executive branch, and the courts where the regulation of licensed professions is concerned. For example, after numerous reports of problems at the Medical Board were published in 2002, the Department of Consumer Affairs named CPIL Administrative Director Julie D'Angelo Fellmeth as its Enforcement Monitor, charged over a two-year period with an in-depth investigation and review of all of the Medical Board's practices, policies, and operations. Two major pieces of reform legislation were enacted mirroring the Monitor's many recommendations. CPIL staff have also played key, outside monitoring roles at the State Bar and the Contractors' State Licensing Board.

While it must be underscored that the overwhelming majority of CPA auditors perform their functions admirably and honestly, the last two decades have seen some catastrophic ethical lapses with life-destroying consequences for millions of investors and the world economy. As two CPA educators observed:

The accounting process and the information it provides is critical to business. The technology boom and bust of the late 1990s and the current subprime credit crisis are clear evidence of the importance of fundamental accounting information, concepts, and their professional implementation and monitoring. **The blatant disregard of basic accounting and auditing concepts was evident in the subprime sector. The failure of lenders and their auditors to perform a simple verification of borrowers' income and credit histories is a contributing cause of this ongoing crisis.**

There is significant blame to be shared by many other parties, including legislators, regulators, financial firms, lawyers, bond rating companies, realtors, mortgage brokers, and homeowners. The reputation of the accounting profession depends to a large degree on the quality of the critical attest function it provides to the public. **Thus, more than other parties, auditors must learn from these repeated and seemingly ongoing professional failures. Poor loan underwriting practices should have been easily identified in even the most basic of audits and then should have been adequately addressed.**¹

Some CPA educators have long advocated for more ethics in CPA education. Consider this example from the January 2007 *CPA Journal* (emphases supplied):

"Accounting Ethics Courses: Do They Work?"

By David F. Bean and Richard A. Bernardi

Those opposed to adding a required ethics course in accounting have stated that there is no proof that such a course would result in more-ethical behavior. In the absence of such proof, the proposal to require ethics education in the accounting curriculum is dismissed by supposedly unbiased and learned opponents. **The authors, however, and many others, are deeply concerned that ethics courses are challenged while the place of other courses in the curriculum goes unexamined.** Curriculum review should be an ongoing process at institutions of higher education. If one is concerned with outcomes assessment, then the burden of proof should be applied equally to all accounting courses, not just ethics. Is this double standard a positive contribution of academia to the accounting profession?

Consider an outcomes assessment of courses after Enron and WorldCom. **Besides being ethical failures, these scandals also represent failures of the accounting curriculum, if one uses the proposed measurement standard suggested for ethics. The failed audits of Enron and WorldCom not only challenge the effectiveness of auditing courses, they also reflect poorly on what is being taught in intermediate accounting courses. The WorldCom fraud goes to the heart of the introductory financial accounting course; had its auditors heeded the definition of assets as items having future value and expenses as items having no future value, the WorldCom audit would not have failed.** Viewed in such a light, even an introductory course would not receive a positive outcome assessment.

Kohlberg's Moral Development

¹ "Accounting Implications in the Subprime Meltdown," *CPA Journal* (December, 2008), www.allbusiness.com/trends-events/audits/11729624-1.html, -- emphases supplied
William M. VanDenburgh, PhD, Robinson, Farmer, Cox Faculty Fellow Assistant Professor of Accounting, James Madison University, Philip J. Harmelink, PhD, CPA, Professor of Accounting, University of New Orleans.

One of the theories covered in most introductory ethics courses is the Kohlberg model of moral development (Lawrence Kohlberg, "Stages and Sequences: the Cognitive Development Approach to Socialization," *Handbook of Socialization Theory and Research*, edited by D. Goslin, 1969). Kohlberg describes moral development as a series of six progressive stages that describe the logic used in making decisions in situations involving ethical components. At stage two, an individual uses a cost/benefit relationship that focuses on oneself. In stage three, an individual focuses on oneself and one's close circle of friends, maximizing benefits after carefully considering the costs involved. In stage four, the reasoning process is focused on following the rules of the individual's society (or profession). In this stage, an individual is concerned with following the rules as the price of membership in the society or profession (i.e., a rules-based approach). Finally, at stages five and six, the individual includes considerations of what one should do in a situation free of the constraints of the lower-stage levels (i.e., a concepts-based approach).

In Kohlberg's model, an individual's level of moral development is at a distinct level at any given point. While reasoning is primarily at one dominant stage, others maintain that some decisions can also be based on reasoning using higher- or lower-stage level considerations (James R. Rest, *Moral Development: Advances in Research and Theory*, 1986). Rest maintains that individuals have different levels of sensitivity to ethical situations. The most frequently used measure of one's moral development is Rest's Defining Issues Test, which measures an individual's level of moral development (James R. Rest, *Defining Issues Test*, 1979). Scoring on this test is based on the proportion of stage five and stage six considerations used in one's decision process. Higher scores on the Defining Issues Test reflect reasoning about what should be done rather than rigidly following a set of rules (stage four) or looking out for oneself or one's friends (stages two and three).

Following the Rules

The Kohlberg-Rest model has been used in numerous accounting ethics studies, **which note that accounting students and practitioners score lower on Rest's Defining Issues Test than does the general population of students and college graduates.** Many researchers speculate that this phenomenon is the result of being part of a profession that inculcates a "following the rules" mentality (i.e., stage four). Following the rules is a lower level of ethical reasoning that the profession has used as a comfortable excuse: "We did everything we were required to do."

Unfortunately, recent audit failures indicate that everyone should be more sensitive to the ethical implications embedded in the audit environment. For example, the leadership of Deloitte & Touche believes that the accounting profession has "always strived to 'follow the rules.' But in the wake of scandals and the loss of investor confidence, we obviously must do more to restore public trust" (William G. Parrett, "Globalization's Next Frontier: Principled Codes of Conduct That Bolster the Rule of Law," speech to International Center for Corporate Accountability, May 14, 2004). As Parrett suggests, the profession must consider what we should be doing rather than just meeting basic requirements. This is the challenge of an accounting ethics course:

Students must be exposed to the real challenges of auditing and the need to maintain a critical mentality when examining a client's data.

Ethical Sensitivity and Auditing

Researcher and coauthor of this article Richard A. Bernardi examined fraud detection using a sample of 342 audit seniors and 152 audit managers from five of the former Big Six firms (Richard A. Bernardi, "Fraud Detection: The Effect of Client Integrity and Competence and Auditor Cognitive Style," *Auditing: A Journal of Practice & Theory*, 1994). One-third of Bernardi's sample was told they were auditing a high-integrity client, one-third a low-integrity client, and the remaining third was not provided with any explicit integrity information; all other data contained in the work papers were identical. Not surprisingly, the study found that managers detected the embedded fraud at a higher rate than did seniors (5% and 42%, respectively), an experience effect. Bernardi also found that managers who scored higher on Rest's measure of ethical sensitivity detected fraud at a higher rate when provided with client integrity data, either high or low, than did the managers who scored lower on Rest's measure (75% and 47%, respectively). Audit managers in the control group who scored high on Rest's measure but were not provided with client integrity data fared no better than did managers who scored lower on Rest's metric (54% and 56%, respectively).

Further research found that managers used a more conservative estimate of materiality as their scores on Rest's measure of ethical sensitivity increased (Richard A. Bernardi and Donald F. Arnold, "The Influence of Client Integrity and Competence and Auditor Characteristics on Materiality Estimates," *The Irish Accounting Review*, 1994). Auditors who scored higher on Rest's measure also were more likely to disclose sensitive findings even when management threatened retaliation (Donald F. Arnold and Lawrence A. Ponemon, "Internal Auditors' Perceptions of Whistle-Blowing and the Influence of Moral Reasoning," *A Journal of Practice & Theory*, 1991) and were less likely to underreport billable hours (Lawrence A. Ponemon, "Auditor Underreporting of Time and Moral Reasoning: An Experimental-Lab Study," *Contemporary Accounting Research*, 1992). **In sum, the existing research demonstrates the benefits of being more sensitive to ethical issues in an auditing context.**

Accountants' Level of Ethical Sensitivity

Having demonstrated the importance of increased ethical sensitivity, it is disturbing that, in an analysis of prior studies, **the authors found that accounting majors' scores on Rest's measure are consistently below that of the general population throughout and after college** (Richard A. Bernardi and David F. Bean, "Establishing a Standardization Sample for Accounting Students' DIT Scores," presented at the Northeast Region of the American Accounting Association's Annual Conference, Portsmouth, N.H., 2006). Another study provided data demonstrating that an accounting ethics course can increase a participant's ethical sensitivity as measured by Rest's Defining Issues Test (Mary Beth Armstrong, "Ethics and Professionalism in Accounting Education: A Sample Course," *Journal of Accounting Education*, 1993). Armstrong tested all students at the beginning and the end of the semester (i.e., pretest and post-test

methodology). 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.

Armstrong's recommendation closely approximates the National Association of State Boards of Accountancy's (NASBA) original **proposal that ethics in the accounting curriculum should include a triad of ethics instruction comprised of an ethics philosophy course, ethical coursework in the accounting curriculum, and a capstone ethics and professionalism course.** The authors believe that the research needed to show an association between an ethics course (Armstrong) and outcomes assessment in an audit environment (Bernardi) has already been done. Why have the profession and academia chosen to ignore these and many other ethics research studies when debating whether an ethics course should be included in the accounting curriculum?

NASBA's Proposal

NASBA's original proposal for a three-course ethics sequence parallels the current accounting course sequence: two introductory courses prior to two intermediate accounting courses, followed by advanced accounting. The initial course should be taught in the liberal arts context and cover the spectrum of theories in ethics. What is questionable is whether all business majors should be required to take a business ethics course as covering ethics "across the curriculum" [Association for the Advancement of Collegiate Schools of Business (AACSB), *Ethics Education in Business Schools*, 2004]. Finally, a discipline-specific accounting ethics course taken during the same semester that a student takes auditing would provide a synergy not in the current curriculum.

This three-course sequence should provide the profession with auditors who are more ethically sensitive. Given the number of courses that must be taken to qualify for the CPA exam, it is inconceivable that every one would be considered more important to those entering the profession than an accounting ethics course.

The Need for the Ethics Course

Accounting scandals in large companies and organizations generate notoriety and often result in adverse publicity for the accounting profession. Many practitioners can relate their own stories involving small and family businesses, and although the economic impact may not have been as great, the personal devastations suffered were just as severe.

Certainly no single ethics course or group of ethics courses can guarantee that students will always behave and act ethically. Similarly, there is no guarantee that those taking accounting courses will always properly account for a given transaction. An honest assessment of the errors and omissions that experienced professionals encounter when reviewing the work of less-experienced colleagues clearly demonstrates that having an accounting degree does not guarantee accurate or proper accounting. Individuals would probably concur, however, that

the probability of correct and ethical choices increases with increased education in these particular subject areas. **An accounting ethics course should lessen the frequency and severity of ethical lapses in the profession.**

Organizations and reporting requirements evolve to address the increasing complexity of events and transactions. There is a need for ethics education of professional accountants that enables them to grow beyond the simplistic rules of right and wrong that were learned in childhood. Accountants need more-advanced tools to fulfill their societal obligations in this increasingly complex environment with its many shades of gray.

Ethics is of primary importance to the accounting profession, and the profession clearly has the right, if not the obligation, to require an accounting ethics course as a condition of admittance. The academic community is entitled to determine the quantity and nature of accounting courses that are offered. Each institution of higher education, however, has the prerogative to determine its curriculum, and there a collective agreement is not required. Accounting students can study accounting ethics either at the institution they are attending or, if not offered at their institution, at a different institution. The authors believe that if academia continues to collectively oppose a course in accounting ethics, it would be in the accounting profession's best interest to create and offer its own accounting ethics course as a precondition of entry to the profession."

Current law for all of these reasons requires ethics education in California.

Moreover, this law embraces an historic compromise between consumers and the profession to fill up the so-called "hollow" 30 with coursework directly traceable to meaningful outcomes for consumers. The law provides terrific flexibility to the Committee as to how to calculate the ten units and what academic or practical work experience satisfies the requirement. Indeed, that the Legislature delegated the task to the Committee and the Board demonstrates its willingness to be practical-minded.

Self-evidently, the ten units to require a significant amount of ethical training. While it may be alluring to debate the wisdom of requiring ethics and the number of specific units required, respectfully, the Legislature has already set the policy in both of these matters.

CPIL's commitment to the profession was and remains that should the ten units prove simply unworkable notwithstanding the flexibility in current law specifically included at the behest of the profession to ease implementation, CPIL in good faith would be willing to entertain an alternative number of units. But practical unworkability is not the same thing as a simple disagreement with the number of units or the policy underpinning the number and, respectfully, the burden is on the Committee to make a record that differentiates clearly between the two.

We therefore hope that the Committee that the Legislature charged with implementing the ten units will apply all of its energies toward the urgent task of implementation.

As for the number of possible courses to satisfy the requirement, the relevant discussion was about making the law flexible enough so that, for example, portions of courses or independent study could possibly satisfy the requirement.

I am uncertain if I can attend the next Committee meeting on the 26th. I would welcome the chance to speak to any individual Committee members to answer any questions they may have.

Sincerely,

A handwritten signature in black ink, appearing to read "Ed Howard", written in a cursive style.

Ed Howard, Senior Counsel, CPIL

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March 14, 2010

Auditor Could Face Liability in Lehman Case

By MICHAEL J. de la MERCED

Lehman Brothers may have collapsed a year and a half ago, but fallout from its demise has created a potential legal liability for its former accounting firm, Ernst & Young.

A 2,200-page report by a court-appointed examiner, Anton R. Valukas, on Lehman's collapse has plenty of criticism for various players involved with the investment bank. But some of his harshest words are reserved for Ernst & Young and the accounting maneuvers it permitted.

Mr. Valukas writes that he found enough evidence to support at least three claims against the accounting firm for not looking more closely into Lehman's use of questionable accounting. Lehman used the tactics, known inside the bank as Repo 105, to hide as much as \$50 billion off its balance sheet to temporarily reduce its debt levels.

His report concludes that sufficient evidence exists to bring claims of malpractice against the accounting firm on the grounds of failing to disclose or investigate the technique. Legal and accounting experts say that Ernst & Young could now face potentially damaging civil litigation by private plaintiffs or the Securities and Exchange Commission — or even criminal charges by the Justice Department.

The examiner's report has again led financial experts to question how accounting firms can fail to closely scrutinize their clients' bookkeeping. Ernst & Young's actions came after the passage of laws like the Sarbanes-Oxley Act of 2002 in the wake of the Enron and WorldCom accounting scandals and the collapse of Arthur Andersen for its role in those frauds.

Ernst & Young itself paid an \$8.5 million fine to the S.E.C. in December for its role in allowing another client, Bally Total Fitness, to avoid restating its earnings in 2002 when accounting rules changed.

Charlie Perkins, an Ernst & Young spokesman, said in a statement that the firm's last full audit of Lehman was for the 2007 fiscal year and that it stood by its results. "After an exhaustive investigation the examiner made no findings in his report that Lehman's assets or liabilities were improperly valued or accounted for incorrectly in Lehman's November 30, 2007

financial statements,” he said.

“One thing Sarbanes-Oxley reminded us of is that technical compliance isn’t enough,” said Lawrence A. Cunningham, a law professor at George Washington University. “Accounting firms need to be sitting back the whole time and thinking, is this a fair presentation?”

He added that any large judgment against the accounting firm, let alone tough regulatory action, could prove enormously damaging in terms of both money and future business.

“If a breach of liability is established here, this could be disastrous in my view,” he said.

According to the report, Ernst first learned of Lehman’s use of Repo 105 in 2001, shortly after it was designed. Partners of the accounting firm told Mr. Valukas that at the time, Ernst had not signed off on Repo 105 on anything more than a “theoretical” level, and gave approval only of Lehman’s internal policy regarding the practice.

At no point did Ernst review the approval letters by the British law firm Linklaters, the only outside legal counsel Lehman could find that would sign off on the practice.

By 2007, Mr. Valukas writes, Ernst was aware of \$29 billion in Repo 105 transactions. While Ernst knew of the practice for years, the issue of Repo 105 was thrust to the fore in spring 2008. On June 12, two Ernst partners, William-Schlich and Hillary Hansen, met with Matthew Lee, a Lehman executive who had written senior management a letter to complain of what he saw as accounting improprieties.

The firm was “also dealing with a whistle-blower letter, that is on its face pretty ugly and will take us a significant amount of time to get through,” Mr. Schlich wrote in a June 5 e-mail message to colleagues, the examiner’s report said.

At that meeting, Mr. Lee informed the two accountants that Lehman was using Repo 105 to move \$50 billion of the firm’s assets off its balance sheet at the quarter’s end to make its debt levels look smaller. The firm reassumed those assets about a week later.

But the next day, Ernst spoke to Lehman’s audit committee — but did not disclose Mr. Lee’s allegations on Repo 105.

Mr. Perkins said Ernst never concluded its review of Mr. Lee’s claims because Lehman filed for bankruptcy before the firm could finish its audit.

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Bell's auditors should have spotted most of the alleged corruption, state controller finds

December 21, 2010 | 2:58 pm

The state controller's office Tuesday issued a scathing review of the work performed by Bell's outside auditor, saying that most of the alleged corruption in the Los Angeles County city would have been identified earlier had the firm done its job.

The long-awaited audit said Mayer Hoffman McCann repeatedly failed to follow basic fieldwork practices when it audited the city's books.

Mayer Hoffman McCann "appears to have been a rubber stamp rather than a responsible auditor committed to providing the public with the transparency and accountability that could have prevented the mismanagement of the city's finances by Bell officials," state Controller John Chiang said in a news release.

The 153-page review said that Mayer Hoffman did not look hard enough for documentation and evidence to support city records.

Chiang's office said it was forwarding the review to the state Board of Accountancy for possible disciplinary action.

The review notes that the auditing firm disputes the findings.

Chiang's report is the latest critical look at a city that has been enveloped by scandal since The Times revealed the enormous salaries paid to administrators and part-time politicians in one of Los Angeles County's poorest cities.

Bell is now teetering on the edge of insolvency and may have to take drastic steps such as disbanding its police department to balance the city's finances. The Times has reported that Rizzo also loaned city money to co-workers, council members and businesses and urged police and code enforcement officers to increase city revenue by aggressively citing motorists, residents and business owners.

The controller's office found that the city had overcharged property owners and businesses more than \$6 million in fees and had mysteriously placed \$23.5 million in bond funds into a checking account that paid no interest, costing the city about \$1.7 million in potential earnings.

In September, Chiang's office said Mayer Hoffman McCann should have noticed the glaring lack of internal controls in Bell. Chiang's report said Rizzo appeared to have complete control of all financial transactions and activity in the city.

Hallye Jordan, a spokeswoman for Chiang, said at the time that state auditors were baffled by "how a CPA firm could miss the abuses the controller's office found, and found rather quickly."

Bell was not the only city with auditing problems. A Times review of state and local records found that the independent audits cities are required to obtain frequently fail to uncover fraud and mismanagement.

Many cities hit with corruption or mismanagement allegations over the past decade, including San Diego, Compton and South Gate, received clean audits, even in cases where officials later were sent to prison.

When firms provide negative audits, they risk being replaced. In the case of Victorville, for instance, the new auditors gave the city a clean rating after the previous auditor found numerous problems.

-- Jeff Gottlieb

The New York Times

Room for Debate: A Running Commentary on the News

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What's Wrong With Accountants?

Ernst & Young may soon be sued for its role as auditor of Lehman Brothers. What kind of oversight do accounting firms need?

Getting at the Truth

Updated December 21, 2010, 10:28 AM

Bethany McLean, a contributing editor at Vanity Fair, is the co-author of "All the Devils Are Here: The Hidden History of the Financial Crisis."

In the wake of Enron's collapse in the fall of 2001, Congress passed the Sarbanes-Oxley Act. Among other things, the federal law was intended to fix the problems in the accounting industry that helped enable Enron by separating the accounting profession from lucrative consulting businesses. This separation was meant to remove the conflict of interest that supposedly prevented the accountants from telling the truth.

Here we are today, and the news breaking that Andrew Cuomo might file suit against Ernst & Young for its role in helping Lehman Brothers mask the extent of its problems. Wait! Didn't we fix all that?

Well, no. The problems in the accounting industry run deeper than a mere separation between consulting and accounting.

Today's financial industry may be too complex and too subject to opinions for the accountants to get right, even if they want to. Witness PricewaterhouseCoopers, which audited both Goldman Sachs and AIG. At the height of the financial crisis, the exact same securities on each firms' books were valued at radically different prices. In other words, there was no way to compare the two firms' results.

The complexity makes the accountants even more susceptible to pressure from management. That pressure is all too real. And the problem in Enron's case was never the consulting business. It's that the accountants forgot who they were working for. They're supposed to work for investors, not management. Their job is to make sure investors have a fair chance at assessing a company's financial condition.

Until the accountants remember that, there will be more headlines. Which gets to the deepest underlying problem of all: There is no way to legislate an attitude change.

Topics: Andrew Cuomo, Business, Ernst & Young, Law, Lehman Brothers

Today's financial industry may be too complex and too subject to opinions for the accountants to get right, even if they want to.

Room for Debate: A Running Commentary on the News

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Updated December 21, 2010 05:25 PM

What's Wrong With Accountants?

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Introduction

The New York attorney general, Andrew Cuomo, on Tuesday sued the accounting firm Ernst & Young, accusing it of helping Lehman Brothers "engage in a massive accounting fraud" by misleading investors about the health of the investment bank, which collapsed in 2008. The suit is the first major action by a regulator against an accounting firm in connection with a central player in the financial crisis.

Ernst & Young was severely criticized in a report issued in March by a court-appointed examiner, which concluded that it permitted Lehman to hide as much as \$50 billion off its balance sheet to reduce its debt levels temporarily.

The Sarbanes-Oxley Act of 2002 was supposed to deal with the failure of accounting firms to scrutinize their clients' bookkeeping practices. Why hasn't that been sufficient? Are other kinds of oversight needed?

Read the Discussion »

Debaters

Getting at the Truth



Bethany McLean, co-author, "All the Devils Are Here"
Window Dressing and Fraud



John C. Coffee, Jr., Columbia University Law School
Why Misconduct Is 'Normal'



Lynn Stout, U.C.L.A. Law School
Problems With Accounting Standards

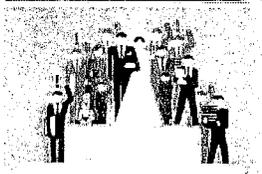


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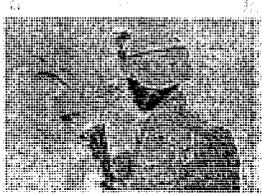
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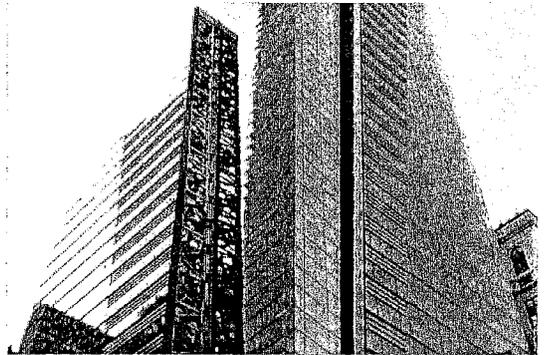
Are New York's Bike Lanes Working?



Why Remarry?



Obstacles to Leaving Afghanistan



Lucas Jackson/Reuters

Ernst & Young's headquarters in New York on Monday.



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December 13, 2010

Attachment #3

Patti Bowers, Executive Officer
California Board of Accountancy
2000 Evergreen Street, Suite 250
Sacramento, CA 95815-3832

Dear Ms. Bowers:

Thank you for the opportunity to share insights developed during the long process to implement the 150 hour requirement as the only pathway to licensure in California. Developing national parity for California CPAs has been a major goal of the CPA profession in California for decades. The majority of California CPA candidates are currently choosing to be licensed under pathway 2 which requires completion of 150 hours of education. Legislation was introduced in 2009 to sunset the non-150 hour pathway to retain a "Substantially Equivalent" designation by the National Association of State Boards of Accountancy for California. Failure to retain this designation for California would have hampered California CPAs' ability to engage in interstate commerce on behalf of their clients and resulted in a loss of jobs with severe consequences for both California consumers and CPAs. With those issues in the background, CalCPA negotiated in good faith with the major opponent to previous legislation, the Center for Public Interest Law. CalCPA was not attempting to impose a fixed the number of ethics units required for licensing candidates, we were simply attempting to enact legislation that would meet the national minimum standard for entry to the CPA profession.

How did the Legislature come to specify the total number of units of ethics study at minimum of 10, as opposed to setting it at a lower or higher number?

Ten units was advanced by the Center for Public Interest Law as a condition to not oppose the legislation and agreed to by the California Society of Certified Public Accountants with the understanding and stipulation by all parties to the negotiation, that if the Committee found the number of units to be infeasible all the parties would weigh heavily the views of the Committee as to the number of units of ethics that were feasible.

What discussions occurred regarding the number of possible courses available to meet the requirement?

To our knowledge no discussions were held regarding the number of possible courses available to meet the requirement. What was discussed was the fact that ethics is embedded in much of the existing curriculum related to business, accounting, taxation and auditing subjects. Again, thank you for the opportunity to respond. Let us know if we can be of additional assistance.

Best regards,

A handwritten signature in cursive script, appearing to read "Bruce C. Allen".

BRUCE C. ALLEN, Director
Government Relations