Tone At The Top – Part II

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Part I of this article, which appeared in the June issue of The Metropolitan Corporate Counsel, *began with an overview of the Treadway Commission's finding that "tone at the top" can be a factor in fraudulent financial reporting. The authors cited an example of such a case less publicized than the infamous cases of fraud at Enron, Tyco and Healthsouth. Part II continues with more examples of poor "tone at the top" as well as insights into possible solutions.*

B. Nortel Networks Corp.

In 2005, Nortel Networks Corporation reported the results of its Audit Committee's investigation into events that resulted in "significant" excess liabilities – approximately $900 million – maintained on the balance sheet that needed to be restated. As Nortel's Audit Committee found, former corporate and finance management endorsed accounting practices that did not comply with GAAP, and employees carried out these improper accounting practices.

First among the causes of this inappropriate conduct was that "management 'tone at the top' conveyed the strong leadership message that earnings targets could be met through application of accounting practices that finance managers knew or ought to have known were not in compliance with U.S. GAAP and that questioning these practices was not acceptable."[1] Also cited among the causes was a lack of technical accounting expertise, which fostered accounting practices not in compliance with U.S. GAAP.[2]

In particular, Nortel's former CEO drove senior management in his finance organization to achieve Earnings Before Taxes ("EBT") goals that the CEO set with his senior management team. The CEO and his senior management team realized that EBT targets could be achieved by exercising inappropriately broad discretion in setting the reserves for various exposures as well as the timing of the release of these reserves. This practice, which was utilized company-wide, allowed business units to "close the gap" between actual EBT and EBT targets. Nortel's former CEO and his senior management team viewed their reserving practices as exploiting a "gray area."[3]

Nortel also relied on its inappropriate reserving techniques for other purposes. In 2002, in order to avoid the payment of "stay" bonuses – bonuses designed to bolster low morale and encourage employees to remain at the company. Nortel's CEO concluded that reserves should be set to cause a loss in the fourth quarter, which loss ensured that the company did not report a profit and thus had no obligation to pay "stay" bonuses. Accordingly, over a two day period, Nortel's CFO and Controller, along with others in the finance organization, identified and recorded $175M in exposures requiring reserves.[4]

Throughout the period during which Nortel was inappropriately recording and releasing reserves, senior management, including Nortel's controller, misrepresented that Nortel's reserve release practices were in accordance with GAAP. Neither the controller nor the CFO advised the Audit Committee that the company's reserving practices were required to achieve profitability and make up for shortfalls in operational results.[5]

C. Krispy Kreme Doughnuts, Inc.

Krispy Kreme reported in August 2005 that a special committee of its board of directors was investigating conduct by its former CEO and COO that suggested that both officers managed earnings in order to consistently exceed projected earnings by a penny each quarter. In particular, the special committee focused on the structuring and timing of equipment sales to franchisees to allow for improper revenue recognition or improper expense reduction.[6]

As a result of this investigation, the Company determined that it had at least two material weaknesses: 1) failure of senior management to set an appropriate tone at the top; and 2) a failure to employee accounting personnel with sufficient knowledge, experience, and training in GAAP.[7]

D. Autobytel Inc.

In August 2006, Autobytel announced the resignation of its outside auditors, PwC. In its 8-K, Autobytel discussed its identified and reported material weaknesses as consisting of:

• failure of senior management to set appropriate tone at the top; and

• failure to maintain "a sufficient complement of personnel with an appropriate level of accounting knowledge, experience and training in the application of generally accepted accounting principles."[8]

E. GMH Communities Trust

In July 2006, GMH reported several material weaknesses in entity-level controls. Specifically, GMH reported that senior members of management "exerted significant pressure on [GMH's] former Chief Financial Officer and other accounting personnel to account for certain transactions in a manner that would permit the Company to report financial results that were 'in line' with the Company's previous Guidance for Funds from Operations ("FFO") for the fourth quarter of 2005."[9] GMH further reported that:

> [c]ertain senior members of management were found to have exerted significant pressure by requesting that our accounting personnel advance the Company's position with its independent registered public accounting firm, Ernst & Young LLP, even when those accounting personnel did not believe that those positions were in accordance with GAAP.[10]

GMH also reported that "numerous errors were uncovered which may have resulted from the perceived pressure placed on our accounting personnel."[11] According to GMH, it did not have sufficient accounting personnel with sufficient knowledge of and experience with GAAP to ensure the preparation of accurate interim and annual financial statements in accordance with GAAP.[12]

F. Common Denominators

The tone at the top problems identified in each of these cases have a number of striking similarities, most of which the Treadway Commission anticipated almost 20 years ago. Each company was managed by objectives and results, with its senior management driven to meet or exceed marketplace's and analysts' expectations. In other words, senior management's primary – if not exclusive – focus was on the short-term goal of "making the numbers." To meet the company's earnings objectives, senior management regularly put financial incentives in place to motivate subordinates to achieve senior management's goals. At the same time as senior management was pressing subordinates to act "creatively" to make the numbers, the companies' internal auditing function was not properly staffed with personnel with knowledge of GAAP or with sufficient work experience to resist attempts to compel inappropriate accounting.

IV. Possible Solutions

In the absence of whistleblower complaints or other similar events that compel the assessment of tone at the top, it is often difficult for directors to find the occasion to question whether senior management has created and is maintaining an appropriate corporate environment. However, as the examples discussed above demonstrate, careful monitoring of tone at the top is very important.

First, directors should endeavor to promote a strategy of focusing on the long term interests of company. Companies should adhere to long-term strategies and not deviate from those strategies simply to realize an immediate benefit to "make the numbers."

Second, directors should ensure that internal audit functions are properly staffed. Experts in GAAP accounting from outside the company should be hired and supported. In addition, regular training should be provided to members of the internal audit function, particularly as the company grows and new accounting issues are encountered.

Third, directors should ensure that sufficient procedures are in place to encourage the reporting of wrongdoing and protect those who report suspected wrongdoing. Directors should confirm that the company's anonymous hotline through which complaints and concerns are brought directly to the Audit Committee is operating effectively.

Fourth, directors should ensure that the company's Code of Conduct sets forth company-wide expectations of ethical conduct and makes clear that those who report suspected wrongdoing will not suffer any reprisals.[13]

Fifth, directors should consider conducting a cultural audit in which the following is assessed:

• whether the corporate culture is inappropriately affected by analysts' or the marketplace's expectations;

•whether fear – fear of losing one's job, failing to meet performance targets, or failing to qualify for incentives – permeates the corporate culture; and

• whether compensation and incentive plans may or could encourage inappropriate forms of earnings management.[14]

Lastly, directors should consider the following:

• whether a mandatory, multi-session formal training, led by experienced counsel and other appropriate resources, should be conducted for senior management on the duties and responsibilities of being a public company. Part of this training should include a discussion on the fundamentals of GAAP accounting. The company's in-house counsel should conduct periodic training sessions and distribute literature about current developments affecting public companies;

• whether, to ensure the independence of the CFO and other key senior management, employment agreements should provide for an appropriate term of years and either do not link bonus to company performance or minimize that component of compensation. In addition, consideration should be given by the Compensation Committee to whether severance provisions should be included in the employment agreements;

• whether the Audit Committee has taken steps to ensure that all accounting policies have been reviewed by the company and are known to all accounting and operations personnel. If it is discovered that all accounting policies have not been followed, the Audit Committee should ensure that any and all corrective action is taken promptly. The company should also consider requiring appropriate subcertifications from business heads regarding compliance with the company's accounting, legal, and operations policies;

• whether the company should distribute its Code of Ethics and have each employee acknowledge receipt and having read and understood it. This process ordinarily should be repeated at least annually. Also, the company should include the Code of Ethics in the new employee package and require all new hires to review the Code and acknowledge that they have read and understood it;

• whether the Compensation Committee should consider if the size of bonuses, particularly in relation to base salary, may create undue pressure to "hit the numbers";

• whether the company should evaluate the necessity of providing earnings and, if appropriate, develop and publish earnings guidance that is sufficiently conservative to reduce the risk that creative accounting will be necessary to achieve the projected results; and

• whether the company should install and/or strengthen controls to ensure that all legal documents, including amendments and side agreements, are reviewed by the Legal Department prior to their execution. The company should confirm with all personnel that no employee is permitted to enter into a contractual relationship of any kind absent the approval of the Legal Department or its designee, and should limit the number of employees who are authorized to execute agreements.

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[1] *Nortel Networks Corp. 8-K of 1/11/2005 ("Nortel 8-K) at 2-3.*

[2] *Nortel 8-K at 2-3.*

[3] *Nortel 8-K at 3.*

[4] *Nortel 8-K at 4.*

[5] *Nortel 8-K at 4-5.*

[6] *Krispy Kreme Doughnuts, Inc. 8-K of 8/10/2005 ("Krispy Kreme 8-K") at 2-3.*

[7] *Krispy Kreme 8-K at 2-3.*

[8] *Autobytel Inc. 8-K/A of 8/10/2006 at 2-3.*

[9] *GMH Communities Trust 10-K of 7/31/05 ("GMH 10-K") at 14-44.*

[10] *GMH 10-K at 144.*

[11] *GMH 10-K at 144.*

[12] *GMH 10-K at 144.*

[13] See *Martin T. Biegelman, Designing a Robust Fraud Prevention Program, Association of Certified Fraud Examiners (Jan./Feb. 2004).*

[14] See *Joseph F. Castellano and Susan S. Lighthe, Using Certified Audits to Assess Time at the Top, The CPA Journal (2005)*

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