Case Study

ANTI-FRAUD COLLABORATION
PROMOTING INTEGRITY IN FINANCIAL REPORTING


LDC Cloud Systems

ABOUT THIS CASE STUDY

This case study was developed as a joint effort by the Center for Audit Quality, Financial Executives International, the National Association of Corporate Directors, and The Institute of Internal Auditors. These four organizations have formed the Anti-Fraud Collaboration to actively engage in efforts to mitigate the risks of financial reporting fraud. The Anti-Fraud Collaboration promotes the deterrence and detection of financial reporting fraud through the development of thought leadership, awareness programs, educational opportunities, and other resources targeted to the unique roles and responsibilities of the primary participants in the financial reporting supply chain. For more information about the Anti-Fraud Collaboration and its resources please visit www.antifraudcollaboration.org.

VIDEOS
LDC CLOUD SYSTEMS COMES TO LIFE

For classroom use, the Anti-Fraud Collaboration has created a video series to accompany the LDC Cloud Systems case study. The videos are available at http://www.antifraudcollaboration.org/resources/videos/

LDC Cloud Systems

BOARD MEMBERS & EMPLOYEES

COMPANY OFFICERS AND MANAGERS

Shep LeDuc, *CEO*
Filippe Arizmendi, *CFO*
Ross Trela, *General Counsel*
Scott Tensar, *Head of Internal Audit*
Beverly Sheel, *Investigator*

BOARD OF DIRECTORS

Dale Torchian, *Chairman*
Shep LeDuc, *CEO*
Wade Beckley (US)*
Lester Darnal (US)**
Darby Gillam (UK)
Deon Khoo (South Korea)
Gary Linhar (US)
Susan Messo (US)
Hulbart Vogel (Germany)*

**Audit committee member*
***Audit committee chair*

EXTERNAL AUDIT FIRM

Sampas Melstram Associates
Latham Asper, *Audit Partner*

Ross Trela, general counsel at LDC Cloud Systems (LDC or the company) felt increasingly uncomfortable with what he was hearing at the hastily scheduled board meeting. Six months earlier, a whistleblower called LDC's hotline to report a possible bribery allegation coming out of LDC's subsidiary business unit in Asia. Trela assigned Beverly Sheel, one of the attorneys on his staff, to investigate. During the course of her investigation, Sheel uncovered an email unrelated to the bribery allegation. The email indicated that accounting irregularities may have occurred at the publicly traded company, and the quarterly historical financial statements LDC had previously filed may have been misstated. While the email had been discovered three months ago, its potential importance was not initially understood, and it had only recently been brought to the attention of LDC's board of directors (the board). Trela was concerned that there seemed to be disagreement amongst board members regarding what the company should do. He was also concerned that LDC needed to file its quarterly financial statements in two days. ■

THE COMPANY

LDC was founded six years earlier by Shep LeDuc to provide technology consulting services and to develop proprietary software applications—and then to sell, install, operate, and maintain those applications at client sites. The company provided services from its US headquarters as well as from its offshore offices located in lower-cost countries around the world. LDC's clients primarily included sharing economy companies—typically companies that created platforms to link independent buyers and sellers. Examples included ride-hailing companies that matched individuals looking for rides with drivers willing to give rides, and home maintenance companies that matched home owners with independent housecleaners. LDC, headquartered in Silicon Valley, initially served customers only in the United States.

The growth of LDC surpassed projections of the executive team and the need for additional funding came sooner than expected. Three years after the founding, LDC held an initial public offering (IPO) to raise capital for its operations. The capital also was intended to enable LDC to move into international markets. Shortly after the IPO, LDC was selling in Europe and Asia. Company executives believed that the market for LDC's services would continue to grow into the foreseeable future. LDC's expansion was going well as both its sales growth and stock price had been increasing significantly faster than industry norms, and the company was the focus of positive news coverage on a regular basis. The

TABLE 1 | LDC FINANCIAL DATA

	Q1	Q2	Q3	Q4	YEAR
Revenue (millions)	$281.2	$303.7	$312.1	$320.5	$1,217.5
Net income (millions)	$20.8	$24.6	$27.8	$32.4	$105.6
Earnings per share (EPS)	$0.78	$0.92	$1.03	$1.19	$3.92
Shares outstanding (millions)	26.5	26.8	27.1	27.2	26.9
Company's EPS estimate	$0.75 to 0.77	$0.85 to 0.88	$0.96 to 0.99	$1.09 to 1.13	$3.67 to 3.77
Analysts' consensus EPS estimates	$0.77	$0.90	$0.98	$1.15	$3.80

rapid increase in the market value of its public float, resulted in the company losing its emerging growth status and LDC therefore faced additional regulatory requirements.[1]

STRATEGY

Shep LeDuc founded the company on the belief that the rapid development of cloud computing and the sharing economy would lead entrepreneurs and established competitors to jump into the market. However, while these emerging competitors may have good ideas, their expertise would be lacking. Traditional consulting and outsourcing firms would offer their services to help, but these companies would lack focus in the specific skill areas needed most. LeDuc, with LDC, aimed to fill this gap.

LeDuc felt it was important to have a global market presence so that LDC could serve customers who had global operations. He also wanted LDC well positioned to provide services to startup companies no matter where they were located. To that end, LDC had opened several sales offices and service delivery sites in key international markets from which it served surrounding geographies. As a particular geographic market developed, LDC's international management team looked for new opportunities within that market to expand in order to meet company growth targets.

This strategy made LDC an attractive employer for engineers looking to apply their cutting-edge skills in these new industries that were expected to be a part of the global economy for decades to come. It also made the company attractive to the best students graduating with technology degrees. LDC made attracting, retaining, and developing top technology talent a high priority. It paid wages equal to, or better than, top tier competitors, offered stock ownership plans, and invested in ongoing training. It also offered perks such as free food and game tables in break rooms. LDC took a similar approach to attract top talent with technology sales and market development expertise.

LDC based its pricing and payment terms on both the type of products and services it sold to a customer and also on the needs and financial position of the customer. For some projects, LDC simply billed the customer for the hours LDC personnel worked on the project and client payment was typically due in 30 days. On other projects, LDC charged licensing fees for the use of technologies it had developed, operated, or maintained for the customer. Royalty payments were typically due monthly. The industry, however, also included many recent startup companies that found it difficult to afford LDC. To reach the best of these companies, LDC may agree to take a percentage of the customer's revenue as a form of payment. For a startup customer just rolling out its own products, this shifted some of its risk to LDC and delayed payment due dates until revenues began coming in. By offering several pricing alternatives, LDC was able to attract customers it might not otherwise reach. At the same time, however, the pricing alternatives made LDC's accounting more challenging to understand.

THE EXECUTIVE TEAM

LeDuc started his career as a sales engineer at a Fortune 500 technology company. He then joined a team that founded a successful software company. Over time, however, he grew impatient and felt there were many opportunities in the technology field that his company simply let go by. He decided to sell his stake in the software company and put everything he had—time, energy, and money—into LDC. He wanted to make LDC a major player in its market, and he displayed the drive to make that happen. LeDuc personally selected the executives on his founding team.

LDC had a six-person executive team and LeDuc worked through them to lead the company. The team consisted of the head of US sales and marketing, the head of international sales and marketing, the head of technology and product development, and the head of operations. It also included Chief Financial Officer (CFO) Filippe Arizmendi and Trela (general counsel).

CFO Arizmendi joined LDC as part of the founding team. Arizmendi had extensive financial experience

1 Under the Jumpstart Our Business Startups (JOBS) Act, companies that go public may be exempt from certain regulatory and disclosure requirements for up to five years or until they achieve $1 billion in total annual gross revenues in their most recent fiscal year. LDC became a large accelerated filer, which brought additional regulatory requirements such as compressed timeframes to file financial reports and mandatory external auditor attestation regarding the effectiveness of LDC's internal control over financial reporting (ICFR) as mandated under the Sarbanes-Oxley Act (SOX), section 404(b).

in spinoffs from established companies, launching and financing new entities, and in merger and acquisition activities. His experience had proven valuable during the IPO.

Trela had joined LDC three years earlier as the company prepared for its IPO. Trela had been in corporate law for his entire career, first at a law firm serving public companies, later in senior positions in the legal departments of two large public companies. He also had served as a board director at a publicly traded company. The LDC position was his first as general counsel, but he felt well prepared for the role. From a legal perspective, there had been few bumps in the road during his time at LDC. However, writing and reviewing contracts, especially those involving alternative pricing agreements, kept him busy and put stress on the legal function. As the most experienced member of the executive team and someone who had spent significant time around the C-suites of public companies, Trela sometimes found himself also serving as an advisor and sounding board to the executive team. He noted, however, that his more aggressive, fast-paced colleagues on the executive team often did not stop long enough to seek advice.

BOARD OF DIRECTORS

When LeDuc founded LDC, he served as the company's CEO and chairman of the board, and largely recruited the company's other board members from executives and directors he had come to know during his career. In the year prior to the IPO, LeDuc pushed for the replacement of three of the original directors with directors who had more international experience. Perhaps most significantly, LeDuc also relinquished the chair position at that time and selected Dale Torchian for the role. As LeDuc explained it, he wanted to focus his time on growing the company, not absorbed with the board, and he thought that having independent directors and a non-executive chair might also give the company more credibility with investors. Overall, LDC had nine directors, and of those, only LeDuc held a management position at the company.

LeDuc had first met Torchian five years earlier at a charity golf event held at the private club where they each owned a vacation home. Torchian had an extensive career as a senior executive in the financial services industry. When the pair met, Torchian was semi-retired; he did some consulting work and served as a director at a mid-sized publicly traded insurance company. LeDuc soon recruited Torchian to join LDC's board, and when LeDuc decided to separate the CEO and chair positions, Torchian seemed to be a great fit.

Lester Darnal, recruited through an executive search firm hired by LeDuc, served as the audit committee chair. Darnal had the most financial expertise on the board. He held an MBA from a top-tier business school and was a CPA. Earlier in his career he had worked in the accounting and finance functions of three public companies, eventually becoming a CFO at a technology company. Along the way, he had served as a board director for two public companies, including one as audit committee chair.

In addition to LeDuc, Torchian, and Darnal, the board also had three US-based directors: Susan Messo, Gary Linhar, and Wade Beckley. Each had held executive positions during their careers; Beckley had also been a board director for a small publicly traded startup. They supported LeDuc's aggressive growth strategy, and wanted to help make LDC a success.

Finally, LDC had three independent, foreign-based directors: Hulbart Vogel from Germany, Darby Gillam from Great Britain, and Deon Khoo from South Korea. LeDuc believed that the future of the company depended on its ability to function in key markets around the world and having directors from Europe and Asia gave LDC insight into these regions. Vogel and Gillam had experience both as executives and as public company board members, though neither had previously served on a US public company board. Khoo had held several executive positions including one as CEO for a time at a mid-sized multi-national manufacturing company; however, prior to LDC he had never served on a board of directors.

The board had three standing committees: audit, compensation, and nominating and governance. Joining Darnal on the audit committee were Vogel and Beckley. Darnal found them both to be hard working and dedicated, but he wished they had more relevant experience for serving on an audit committee. Darnal mentioned this to Torchian explaining that he felt that while Vogel and Beckley perhaps wanted to do the right thing, they did not always understand the various accounting, legal, and regulatory rules that impacted the issues that came before the audit committee. Torchian responded that it was very difficult to assemble and maintain a strong and effective board. Torchian then stated that next year he planned to institute an annual day of training for the board to review and explore board members' roles and responsibilities.

INTERNAL AUDIT

CFO Arizmendi had hired Scott Tensar during the run-up to the IPO for the purpose of creating and heading the internal audit function, and Tensar had continued to report directly to Arizmendi since that time, with a secondary reporting relationship to the board's audit committee. Tensar, who was well-qualified for the position, was responsible for providing assurance that LDC's major risks were being appropriately addressed including financial, operational, and reporting. This included reviewing LDC's internal control over financial reporting (ICFR) that was designed to address the risk of fraud. Tensar and his team had tested these controls and provided assurance that they were designed and operating effectively.

Tensar felt that his internal audit team possessed the skills and experience that were typical for a billion-dollar company. The problem he faced, however, was that he had a wide scope of risks to address. Further, LDC's business model was more complex than was typical given the variety of customer payment models the company pursued, and LDC was growing rapidly and engaging with customers in unusual ways because much of what was happening at the intersection of cloud computing and the sharing economy was unchartered territory for any technology company. There were few models for the company to follow. In Tensar's view, it seemed like everything his team reviewed was more complicated and took a bit longer than he expected.

Tensar had requested a larger budget this past year so he could hire two additional experienced auditors for his team, but Arizmendi denied the request. At the time Arizmendi told Tensar, "If the company meets its current year growth targets, I will recommend that internal audit get more people," but then added: "With the pressure we are under now, there is no chance that LeDuc will approve more staffing for support functions."

Tensar had wanted the larger team so he could keep up with all that was happening and to enable some extra time for training and professional development. At current staffing levels, there was hardly time for him, or members of his team, to catch their breath. Tensar also wanted time to be able to plan ahead. He was sure that LDC's internal audit function was doing the best it could with its resources, but he was concerned that the risks coming from the company's unique business model needed more attention. Tensar recalled a recent conversation with Arizmendi:

Tensar: "I wish I had more time to stop and think. We complete an annual fraud risk assessment but do we miss anything? If someone wanted to commit accounting fraud here, how would they do it? Are there weaknesses in our accounting systems that I am not aware of?"

Arizmendi: "Because of our business model, our finance and accounting systems are so unusual that most of our own people can't figure them out. I doubt someone could learn enough to commit a material fraud without being detected."

Tensar: "You could be right," he said, reluctantly agreeing. "I have not seen any sign of accounting fraud, but you can't be too careful. By the way, Lester Darnal (audit committee chair) stopped by again last week. I like him. He shows real interest in what we are doing and is always asking good questions."

Arizmendi: "Yes, Lester knows his stuff and he loves to always know what is going on. Just be careful with what information you volunteer. We need to get our own work done, and the board sometimes has its own agenda."

EXTERNAL AUDIT

When LeDuc first launched the company, he used a small audit firm that often served technology startups. Eighteen months after the founding, with an IPO on the horizon, LeDuc switched to a larger audit firm. This new firm, Sampas Melstram Associates (Sampas), was well-qualified to conduct audits of LDC and had a network of affiliates in those countries where LDC had subsidiaries. Sampas and LDC had a good working relationship and had had no significant disagreements relating to the audits of LDC's financial statements. Since the IPO, LDC had filed its quarterly and annual reports on time and had never restated any filing. Sampas had issued unqualified audit opinions every year the firm audited LDC.

There had, however, been several difficult situations as Sampas and LDC worked through some unusual accounting challenges resulting from LDC's business model. Sampas audit partner, Latham Asper, had once remarked to CFO Arizmendi and General Counsel Trela: "I appreciate the willingness of LDC's managers to help us understand the business and how it works. You are doing some cutting-edge contracting and pricing and I think it has been a learning experience for all of us. In the end, we get it right."

Asper held periodic meetings at LDC with the board's audit committee and senior executives. Trela often sat in on these meetings. At a recent audit committee meeting, Asper spoke with Committee Chair Darnal:

> **Asper:** "My audit engagement team is seeing signs of stress among LDC's accounting personnel. Have you heard this from others and are you concerned?"
>
> **Darnal:** "I believe they are under stress. There is a lot happening in the business right now. I don't get into the accounting area that often, but I do speak regularly with our internal audit head. He has mentioned how busy everyone is."
>
> **Asper:** "We should both continue to keep an eye on this. I have mentioned this to Shep (LeDuc) and Filippe (Arizmendi, CFO) too. My meetings with them don't tend to last long. They always seem eager to get back to work, but I get the impression they expect a lot out of their people and that the stress is typical."

CULTURE

CEO LeDuc tried to create an air of excitement around LDC. He constantly projected the image that LDC was a great company playing a leading role in the industries of the future. He was proud to be its founder and CEO and proud to work with the LDC team helping the company to reach its full potential.

Those who worked with LeDuc described him as hard charging, someone with high expectations for himself, his business, and those around him. He had a serious demeanor that left no doubt he had a business-first focus. LeDuc demanded his managers put in long hours and meet their commitments. He wanted results and hated excuses when they were not achieved. In particular, Leduc was concerned about maintaining revenue and earnings growth rates, and he reminded his executives that Wall Street analysts cared about those metrics too.

At a recent presentation to LDC's executives and managers at headquarters, LeDuc had stated, "It is very important that we remain aggressive, meet our targets, and get everyone doing their very best to ensure the success of the company. None of us want to look back five years from now and think they let down the team, or that we as a company missed our chance to be something special." Those executives and managers who met LeDuc's standards could share in the rewards, but LeDuc also made it clear that those unable to keep up might not have a future with the company. Indeed, since the IPO, LeDuc had fired two such executives from his top team.

Despite constantly trying to push his team and the business ahead, LeDuc took it as a matter of pride that his company had never missed a quarterly earnings target. This was achieved by hard work and by taking great care when formulating forecasts and budgets to minimize the risk of surprises.

At the same time, LeDuc took his responsibilities as a public company CEO seriously as well. He was often quoted stating, "Don't do anything you wouldn't want your mother to read about in the *Wall Street Journal*." In meetings with his executives or when speaking to groups of LDC employees, LeDuc always said, "Don't do anything that will get us in trouble." He asked his executives to use those same words and to maintain those expectations with their own staff. LeDuc hit these same themes during interviews with the media.

Below the executive team, and further into the company's ranks, the air of excitement created at the top was tempered by the demanding nature of the job. Employees, particularly those using technology skills, generally liked working at LDC and appreciated the opportunity and potential career boost that having LDC on one's resume might provide. The company was developing a positive reputation and this reputation reflected on the staff. However, employees also worked very hard and sometimes felt that budget goals were disconnected from reality and that the only way to meet some targets was to work extra hours for long periods of time. Managers across the company sometimes complained that the executives never liked to hear bad news and were quick to "shoot the messenger."

As one manager explained, "They tell us to always do the right thing, like that only means don't lie or cheat. Well sometimes doing the right thing is easing up on the staff when we are all putting in so many hours. But that would never fly here if doing so risked missing a target."

Some of this stress made its way to the accounting function. For example, managers in the sales function used a variety of techniques to meet their own targets. For some sales managers, this included pushing accounting as far as possible to get things through. The sales managers treated the accounting staff as if they were overly conservative and would use every argument to get something past accounting. The sales managers then felt that everything must be OK once accounting agreed, and seldom considered that they got their way only by pushing the envelope as far as it would go. The accounting personnel often complained that they felt like they were playing goalie, working hard to make sure nothing inappropriate got past them, but feeling that they were overworked and alone in trying to do the right thing. The head of accounting, who reported to CFO Arizmendi, understood how the accounting staff felt, but often reminded them of one of Arizmendi's motivational sayings: "Leading companies have leading expectations."

LeDuc was aware that such feelings existed, and he occasionally discussed these concerns with his executive team. At one executive meeting, LeDuc stated, "This company is in a once in a lifetime position. It is our job to take advantage of that. We must continue to push, and I expect our managers to do the same. That is how we will remain the go-to provider for our customers, meet our potential, and keep our shareholders happy. We can't let parts of this company, especially accounting or legal, hold us back by being overly conservative, or frankly, sometimes a bit lazy. I am not sure they fully appreciate what is happening here and the opportunity we have. When I go home late, sometimes after midnight, I see a lot of the software coders still at it, and I know the long hours and sacrifices our sales teams make to land deals. It can be demoralizing, Filippe (Arizmendi, CFO), when some of your people slow down a deal because they can't figure out the accounting; or Ross (Trela, general counsel), when we reach agreement with a client on a contract only to see a holdup on the legal paperwork. We hire good people, and I have confidence and trust in them that they can do the work. Just set the expectations, and let them do it. Now, I know you are all working hard, and as a company we must always do the right thing, but we are at the leading edge of a fast-moving industry and everyone must keep up."

COMPLIANCE ENVIRONMENT

LDC maintained a code of conduct. Employees signed off that they were informed of the code when they were hired, and supervisors were expected to discuss the code with each direct report during that employee's annual review. The company also maintained a hotline to enable employees, customers, and vendors to report any financial, regulatory, legal, or other concerns they might have with LDC or its personnel. Based on his personal experience and on conversations with his peers at professional functions, Trela believed that LDC's code of conduct, hotline, and other compliance systems were fairly typical in the technology industry. The systems were well intentioned and covered base-line requirements, but they were not something that most staff members thought about very often.

BRIBERY INVESTIGATION

Six months ago, an anonymous caller phoned LDC's hotline and expressed concerns that the head of operations in LDC's Asia unit might have paid a bribe in order to secure permits necessary to expand the business in that region. The caller described overhearing the executive on the phone talking about trying to obtain the permits and then offering to pay for a site selection consultant to make sure the permits came through. The hotline caller found that unusual because the site for LDC's new office had already been secured. The caller then stated, "I didn't think much about it at the time, but then just last week we all took the anti-bribery training. I began to think that what I had overheard might be a bribe, so I decided to call." The caller was referring to a two-hour online training module on anti-bribery rules including the US Foreign Corrupt Practices Act (FCPA). The training, which LDC required all its managers and executives to complete, included a section about prohibited bribes to foreign officials.

General Counsel Trela learned of the call as part of his regular duties overseeing the hotline. The caller did not provide much information, but Trela believed there was enough to warrant an investigation. Trela assigned the case to Beverly Sheel. Sheel, one of the three people on Trela's staff, was a competent attorney and had been with LDC for two years.

When Trela launched the bribery investigation, he let Internal Audit Head Scott Tensar know and also called Latham Asper, the Sampas audit partner. Asper asked Trela why he was conducting the investigation internally; pointing out that many companies would hire an outside law firm for this type of work. Trela responded that there was no way CEO LeDuc would approve spending money on an outside firm if there was any way we could do it ourselves. Asper suggested, and Trela agreed, to have a member of Asper's team shadow Sheel on the investigation. This consisted of occasional meetings at LDC headquarters at which Sheel updated the Sampas team member and answered questions.

When conducting an internal FCPA investigation, one piece of information often led to another, which could cause a reevaluation of earlier discoveries. Because of this, such investigations often took months or even years to complete and this one proved no different. Sheel interviewed executives, managers, and other personnel in the US and Asia. She reviewed strategic plans, financial accounts, and reports. She also read memos, emails, and other communications within Asia and between Asia and the United States. From the start, Trela spoke with senior executives about the importance of giving Sheel complete access to whatever she needed and LeDuc made clear that he expected Sheel to receive full cooperation.

During the bribery investigation, Sheel met occasionally with Trela to provide informal updates and on two occasions when she found something particularly noteworthy, she immediately brought that to Trela's attention. Otherwise, each month, Sheel submitted a formal written report to Trela that summarized her progress to date. Trela, in turn, shared Sheel's reports with the board, the audit committee, and the external auditors. CFO Filippe Arizmendi was not involved in the investigation and did not receive the monthly reports.

Trela recalled one conversation on the topic of the investigation he had recently had with Sheel:

> **Sheel:** "I have not completed the investigation, but it appears that our operations manager in Asia made a payment that could be viewed as a bribe to a government official for building permits for our new site in the north."

> **Trela:** "Why would he do that? There should have been no problems with our expansion there."

> **Sheel:** "I am not sure, but our expansion there is a big part of our Asian growth targets. It appears that the payment removed some final obstacles that threatened to prevent us from opening on time. Had there been any delays, sales would have been below budget."

> **Trela:** "How did he pull it off?"

> **Sheel:** "If my theory is true, he paid $20,000 to a small consulting firm in the region for work relating to the site selection. I have not found a legitimate reason why we would have needed the services of this consulting firm. Further, I have found some evidence that the consulting firm is controlled by the family of a government official. With this type of project, such an expense would not get flagged by our accounting controls. I am surprised at how little we at headquarters seem to know about who is doing what in our Asian operations. But I need more time to get to the bottom of this, and as you know, I have a lot going on. Between this and the legal contracts I am working on, I could use more help. It seems like funding for the legal department is not much of a priority."

Trela understood Sheel's frustration regarding the department's budget and staffing. It seemed like the engineers and sales team got all the attention and glory, particularly when CEO LeDuc talked about how great a company LDC was or when he emphasized recruiting and retaining the very best people in the industry. As for the investigation, Trela knew that LeDuc spoke often about the need to meet growth targets and he wondered if the bribe was as simple as one manager trying to do just that.

Trela also reflected that he had meant to visit LDC's overseas sites to make connections with some of the managers there on their own turf, but with all that was happening at headquarters he had not left California since LDC had opened its first foreign office, in London, several years earlier.

When Sheel dropped off her most recent report on the bribery investigation to Trela, she explained to him that about three months earlier an email had caught her attention as she quickly read through a pile of emails that she had collected as part of the investigation. The email included a list of accounts along with some descriptive text for each one. When she first discovered the email, she meant to try to figure out what it meant, but because it did not appear directly related to her work, and because of the pressure she felt to pursue the investigation while keeping up with her other assignments, she put it off. She remembered the email again while preparing her most recent report and decided to include the email as part of the report and let Trela figure out what to do with it. Trela, who had little finance or accounting experience, mentioned the email to Audit Committee Chair Darnal when he sent him the report.

THE EMAIL

The email had been sent from one mid-level accounting manager at headquarters to another about six months earlier. The message read:

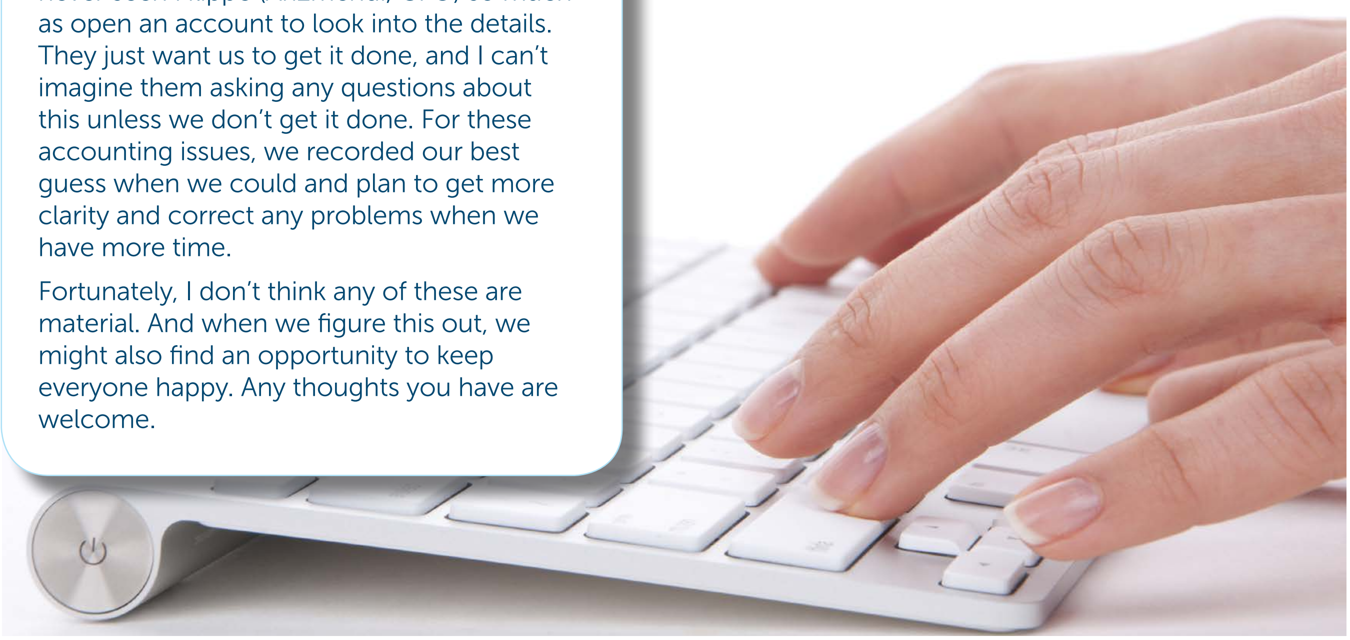
> Bill, here are the accounting issues I mentioned, and as you know, some of these go back a ways. The data that supports these accounts are not always clear and keep changing, and we are not sure what the correct accounting treatment is for these issues. I just wish we had more time to think and make sure everything is right. Trying to keep up with the everyday rush here is like drinking from a fire hose. And the big shots have their own problems and don't want to hear about these types of things. I have never seen Filippe (Arizmendi, CFO) so much as open an account to look into the details. They just want us to get it done, and I can't imagine them asking any questions about this unless we don't get it done. For these accounting issues, we recorded our best guess when we could and plan to get more clarity and correct any problems when we have more time.
>
> Fortunately, I don't think any of these are material. And when we figure this out, we might also find an opportunity to keep everyone happy. Any thoughts you have are welcome.

The email also contained an attachment marked "For Accounting Eyes Only." The attachment contained a list of 16 accounts and each of the 16 had some descriptive text and a dollar range of potential financial statement impact. **(See Appendix 1.)** For example, one item involved a computer equipment amortization expense and had an estimated range of $50,000 to $250,000. Individually, each of the 16 accounts appeared to be immaterial, with estimates ranging from zero to a few thousand dollars; however, a few had higher amounts. The largest item had a range of $0.8 million to $1.2 million.

When Darnal read the email, he quickly became concerned and contacted his colleagues on the audit committee. Given the short period in which they had to take any action before the quarter-end filing deadline and the potential seriousness of the situation, they decided to call together the entire board. **(See Appendix 2 for a timeline of key events.)**

THE BOARD MEETING

Board Chair Dale Torchian: "Thank you for coming together on short notice, and Deon (Khoo) and Hulbart (Vogel) for joining by telephone. And thank you Ross (Trela) for sitting in as well. I asked Shep (LeDuc) to sit this one out, and he agreed, but he asked me to tell



you that he trusts us to do what is right for the company. Ross can you get us started?"

General Counsel Ross Trela: "Yes. You all have the most recent report on our FCPA investigation. The email referenced in the report is the primary reason why we are here. Frankly, I am not sure if we have a significant issue in front of us or not. The email on its face gets my attention, but I don't know what it means, and can't advise on the accounting. When I showed the email to Lester (Darnal), he was concerned enough to bring us together. The time pressure is that we need to submit our quarterly financial report in two days."

Audit Committee Chair Lester Darnal: "I have not had much time to dig into this, but the email was sent six months ago and discovered three months ago, and it is just coming to our attention now. As some of you know, our business model makes some of our accounting a bit challenging. The accounting items in the email appear to be among those that are more difficult for our less experienced managers to understand, but it is not obvious to me why they might appear together in an email. My fear is that because these issues are difficult to understand, they provide a good opportunity to play with the numbers, to change assumptions or make entries to show certain results depending on how a quarter is going. In essence, they could be used to manage earnings coming out of certain units of the business. Also, while this is not completely clear, it appears that many of the accounting issues in the email originated in, or involved, our unit in Asia, though in the email they are being discussed by two of our managers here at headquarters.

Director Wade Beckley (US): "Is this even important? The dollar value of these items seems fairly small. They don't appear to be material."

Darnal: "You could be right. Individually, these items are not material. However, collectively it is possible that they are material because depending on where each item falls in the range, they could very well have resulted in LDC over stating its earnings last year."

Director Hulbart Vogel (Germany): "We don't have time for this now. We don't have clear evidence that this email indicates intentional wrongdoing on anyone's part. If you want to look into this further, then fine, let's get started on that. Give those guys a call and ask them, but let's not hold up filing our quarterly report. It is critical that we file on time, and I am not seeing anything that should prevent that."

Director Darby Gillam (UK): "I agree, let's wrap up the financials on time, let Ross pursue the bribery investigation, and let our CFO figure out what his people are doing in this email. This email was sent six months ago and the attachment does not contain any dates. For all we know, whatever issues it describes could have been taken care of many months ago."

Darnal: "These are all good points. Maybe this is nothing, maybe any problems have already worked themselves out, and I agree that it is very important to file on time. But the problem is, we don't know, and it is clear to me that we need to find out."

Director Deon Khoo (South Korea): "I don't see what the issue is here. Why are we even talking about an email? We got a hotline report about a possible bribe, and it appears that we are thoroughly investigating that. After six months of investigating, we still don't know what happened. I am not convinced that a bribe did occur, and remember, business gets done a little differently in Asia than it does in the US. It appears that our managers in Asia are actively ensuring that our business there does not get delayed. Isn't that what we want them to do? But even if there was a bribe, what does that have to do with this email? Why are we even considering this? Let's finish the FCPA investigation and move on."

As the discussion continued, Trela thought about what action he might recommend to the board. ■

APPENDIX 1

Email Attachment - FOR ACCOUNTING EYES ONLY

YEAR	QUARTER	POSSIBLE ACCOUNT IMPACTED BY ISSUE	DESCRIPTION	ESTIMATED FINANCIAL STATEMENT IMPACT
ONE YEAR AGO	4	Restructuring Accrual	Cost of reorganizing branches within European offices after restructuring efforts, not yet accrued	$10,000 - $35,000
	4	Revenue	Sales recognized after inventory shipment with FOB destination in the Incoterms	$0 - $6,000
	3	Contingent Liability	DartSpot Settlement loss based on current lawsuit outcome	$800,000 - $1,200,000
	3	Revenue	Sending inventory at end of month into our channels to meet sales targets	$250,000 - $500,000
	2	Consulting fee	Cost of interpreter when traveling in Asia to visit LDC local operations	$15,000 - $70,000
	2	Revenue	Revenue recognition potential cutoff exposure from future sales	$100,000 - $300,000
	2	Differed Tax Asset	Writedown of deferred tax asset because the tax law changed, and we have surpassed the deadline to utilize the DTA	$200,000 - $400,000
	2	Inventory	Reserves in our inventory that haven't moved in a few months; not sure what to do with it	$50,000 - $100,000
	1	Payroll Expense	Employee benefits added for recruiting top engineer talent, but not yet accrued	$100,000 - $175,000
TWO YEARS AGO	4	Amortization Expense	Computer equipment used that should have been allocated and expensed	$50,000 - $250,000
	3	Lease Expense	Leasehold agreement increase not yet recognized on the books	$200,000 - $350,000
	2	Tax Credit	Timing of research and development tax credit opportunity potential	$0 - $80,000
	2	Litigation Expense	Settlement with ABC Technology Inc. outside of courts and covering attorney fees	$0 - $1,000
	1	Tax Expense	Backlogged potential tax expense as payroll is recognized	$5,000 - $16,000
THREE YEARS AGO	4	Inventory Writedown	Obsolete inventory still on the books to stabilize current assets	$3,000 - $9,000
	3	Revenue	Revenue recognized on books, although it is placed on consignment currently with our retailers	$15,000 - $30,000

APPENDIX 2

Timeline of Key Events

6 MONTHS AGO

Whistleblower hotline call alleges possible bribe in Asia.

General Counsel Ross Trela assigns staff attorney Beverly Sheel to investigate the bribe.

Email written (later uncovered by Sheel).

3 MONTHS AGO

Sheel uncovers email that references unclear accounting items.

1 DAY AGO

Sheel sends monthly bribery investigation report to Trela and she specifically mentions the email to Trela.

Trela sends the monthly report to the board and the external auditor and he specifically mentions the email to Audit Committee Chair Lester Darnal.

Darnal reads the email, decides it is serious, contacts his audit committee members, and they call for a board meeting.

NOW PRESENT DAY

The board meeting.

2 DAYS FROM NOW

Quarterly financial statements due.

LDC Cloud Systems

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WE WELCOME YOUR FEEDBACK Please send comments or questions to info@thecaq.org.