



Association of Audit Committee Members, Inc.

Dedicated to Strengthening the Audit Committee

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October 12, 2011

James R. Doty, Chairman
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

Re: Whistleblower Policies

Dear Chairman Doty:

The Association of Audit Committee Members, Inc. (“AACMI”) is a non-profit organization devoted to developing best practices for audit committees. I believe that you are familiar with the Chair of our board of directors, Roderick Hills. The views expressed in this letter are my own and do not necessarily reflect the views of the entire board of directors. I mentioned some of these points to Dan Goelzer, who was kind enough to speak at our annual meeting on October 4, 2011.

I believe that the PCAOB should insist that the registered independent accounting firms evaluate the effectiveness of the public company’s whistleblower policies as part of their audit. According to a 2010 survey by the Association of Certified Fraud Examiners, approximately 40% of all frauds is discovered through tips from whistleblowers. The percentage of frauds discovered by independent auditors and internal auditors collectively accounts for only 19% of fraud discoveries, according to the same survey.

Therefore, the whistleblower system within each public company is an important entity level internal control, which is equally deserving of review as the audit committee operations

Unfortunately, many public companies have ineffective whistleblower systems. This was demonstrated in the last financial crisis when high-level executives at various firms, such as Lehman Bros., AIG, etc., failed to use the employee hotline, even though they knew of the major risks that were being taken by the CEO and CFO of these companies. One example would be Matthew Lee, a senior vice president of Lehman Bros., who failed to use the employee hotline to the audit committee even though he was aware of accounting improprieties. (See Bankruptcy Examiner Report – Pages 21, 1460 and 1464.) Another example would be Gene Park, an AIG executive, who was referred to in both the Financial Crisis Inquiry Report and Michael Lewis’ book “The Great Hangover”, who was aware of the huge risk being undertaken by AIG in insuring credit default swaps, but nevertheless failed to use the anonymous employee hotline to the audit committee. Other examples are given in my book entitled “Whistleblowers: Incentives, Disincentives and Protection Strategies” (John Wiley & Sons, Inc., 2012), which will be released in December 2011.



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The primary problem with the current hotlines is that there are no meaningful rewards given to whistleblowers even though executives are risking their career by communicating directly with the audit committee and the failure to provide adequate anonymity protection for executive whistleblowers. (such as permitting them to communicate through a lawyer whose fee is paid by the company if the information is legitimate.) Other problems with existing hotlines are detailed in my new book.

Audit committees can only act on the information that is available to them which, today, comes primarily from the CEO, CFO and the independent and internal auditors. Ineffective hotlines have resulted in audit committees being duped by the CEO and CFO, as has been claimed in financial disasters starting with Enron and ending with Lehman Bros.

Registered independent auditors should be asking the following questions of public companies with regard to their whistleblower systems:

- Does the whistleblower system provide meaningful rewards for legitimate whistleblowers? As discussed in my forthcoming book, the potential for retaliation against executive whistleblowers is so high that they will not risk destroying their careers by becoming whistleblowers without sufficient incentive.
- Is there absolute protection for the whistleblower's identity? Most potential executive whistleblowers will not take the risk of being discovered by the company through having their voices traced by voice recognition software or through computer searches or by the company hiring private detectives. My book suggests that permitting them to hire personal counsel through whom they communicate and permitting them to form entities to further hide their identity is necessary. Although many hotlines permit further questions to anonymous whistleblowers, it is my view that no executive whistleblower would be willing to give his or her contact information to a hotline provider paid for by the company and that the only practical method of asking further questions to an anonymous whistleblower is to permit him or her to obtain a personal attorney.
- Does the compliance policy of the company require the disclosure not only of potential law violations but also of major risk exposures? Many companies today have compliance policies which do not address major risk exposures.



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- Does the whistleblower system have independent administration? My book suggests that potential whistleblowers will not take the risk of using the hotline if the hotline complaints are not independently administered.
- Does the whistleblower system require independent investigation of complaints? Except for minor complaints, potential whistleblowers would not have confidence in a system which permits employees of the company (e.g. internal auditor, inside general counsel, compliance officer, etc.) to investigate complaints.
- Does the whistleblower system require reports to the whistleblower of the progress of the investigation?
- Is there a rule that anonymous complaints should be investigated with the same effort as complaints where the whistleblower is disclosed? A 2010 study by Hunton and Rose indicates that audit committees tend to give less credence to anonymous whistleblowers. The study was of 73 experienced audit committee members having an average of 23 years of business experience.
- Do the motivations and personality of the whistleblower play a role in determining the truth of their allegations? The failure of Harry Markopolis to convince the SEC about the Madoff Ponzi scheme 10 years before it was discovered was due in part to the focus by SEC officials on the motivations of Mr. Markopolis and his difficult personality, according to the report by the SEC Inspector General. The motivations and personality of the whistleblower should not be relevant to the truth of the whistleblower's allegations.
- Are annual reports given to all employees as to actions taken with respect to whistleblower complaints?
- Has there been effective communication of the whistleblower policy to all employees?
- Finally, does the audit committee, as well as the CEO, play an active role in creating a tone at the top?



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I believe that the PCAOB can play an important role in preventing the next financial crisis by insisting that independent auditors view the whistleblower systems of public companies as important internal control mechanisms which require probing questions to be asked of management.

If you have any questions, please do not hesitate to contact me.

Sincerely yours,

A handwritten signature in cursive script, which appears to read 'Frederick D. Lipman'. The signature is written in dark ink and is positioned above the printed name.

Frederick D. Lipman

FDL:bjh