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Ethical Obligations and Decision Making in Accounting

Text and Cases

Fifth Edition

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ETHICAL OBLIGATIONS AND DECISION MAKING IN ACCOUNTING: TEXT AND CASES, FIFTH EDITION

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Dedication

We dedicate this book to all the students we have taught over the years, without whom our burning desire to teach ethics would lay dormant. In this book, we strive to awaken students' interest in ethics and ethical behavior. Our goals are to educate accounting students to be future leaders in the accounting profession, stimulate your ethical perception so that you not only know what the right thing to do is but have the courage to do it, and sensitize you to your duty to serve the public interest above all else.

> "Educating the mind without educating the heart is no education at all."
>
> *Aristotle*

About the Authors

Courtesy of Steven Mintz

Steven M. Mintz, DBA, CPA, is a Professor Emeritus of Accounting from the Orfalea College of Business at the California Polytechnic State University–San Luis Obsipo. Dr. Mintz received his DBA from George Washington University. His first book, titled *Cases in Accounting Ethics and Professionalism,* was also published by McGraw-Hill. Dr. Mintz has been acknowledged by accounting researchers as one of the top publishers of research papers on accounting ethics and accounting education. He was selected for the 2014 Max Block Distinguished Article Award in the "Technical Analysis" category by The CPA Journal. Dr. Mintz received the 2015 Accounting Exemplar Award of the Public Interest Section of the American Accounting Association. He also has received the Faculty Excellence Award of the California Society of CPAs. Dr. Mintz writes three award-winning blogs under the names "ethicssage," "workplaceethicsadvice," and "higheredethicswatch."

Courtesy of Roselyn E. Morris

Roselyn E. Morris, Ph.D., CPA, is a professor emerita of accounting of the Accounting Department of McCoy College of Business, Texas State University. Dr. Morris received her Ph.D. in business administration from the University of Houston. She is a past president of the Accounting Education Foundation. She is currently appointed for a six year term as chair of the Qualifications Committee of the Texas State Board of Public Accountancy (TSBPA) and is a board member of the National Association of State Boards of Accountancy (NASBA).

Both Professors Mintz and Morris have developed accounting ethics courses at their respective universities.

Preface

Ethical Obligations and Decision Making in Accounting was written to guide students through the minefields of ethical conflict in meeting their responsibilities under the accounting professions' codes of conduct. Our book is devoted to helping students cultivate the ethical commitment needed to ensure that their work meets the highest standards of integrity, independence, and objectivity. We hope that this book and classroom instruction will work together to provide the tools to help students to instill the ethical values of the accounting profession and professionalism in everything they do. Here is a brief overview of enhancements to the fifth edition. Additional details follow.

Overview of 5th Edition

An expanded discussion of professional judgment highlights the challenges to ethical decision-making for internal accountants and auditors, and external auditors. New material on behavioral ethics addresses cognitive challenges in the performance of an audit. We examine emerging issues in organizations related to equity, diversity, and inclusion, as well as sexual harassment. We build on traditional philosophical reasoning methods by taking the process one step further, that is, to convert ethical intent into ethical action by applying the "Giving Voice to Values" methodology. GVV coverage has been expanded to include new cases in order to provide instructors with more choices when and how to use GVV in class discussions. Whistleblowing obligations of CPAs are covered in full including the 2018 U.S. Supreme Court decision in *Digital Realty Trust, Inc. v. Somers* that clarifies when an accountant must report financial wrongdoing to the SEC under the Dodd-Frank Financial Reform Act. We also examine whether protections against retaliation under the Sarbanes-Oxley Act are working as intended. A 2018 court decision in *Erhart v. Bofl Holdings* held that whistleblowers can use confidential company documents to expose fraud may be a game changer. In this book, we are committed to thoroughly exploring ethical obligations of accountants and auditors. In that regard, we have expanded discussion of some of the rules of conduct including independence, objectivity and integrity, and professional skepticism. We also devote more coverage to acts discreditable to the profession, a growing problem of professional behavior. New rules to disclose critical audit matters and when to include a separate paragraph in the audit report are discussed. Expanded coverage of non-GAAP metrics raises questions about the usefulness of such data, its conformity with GAAP, and SEC guidelines. Ethical leadership is discussed in the context of professional role, professional obligations as a CPA, and dealing with organizational influences.

Several states now require their accounting students to complete an ethics course prior to being licensed as a CPA. This book has been designed to meet the guidelines for accounting ethics education including:

- encouraging students to make decisions in accordance with prescribed values, attitudes, and behaviors.
- providing a framework for ethical reasoning, knowledge of professional values, and ethical standards.
- prescribing attributes for exercising professional skepticism and behavior that is in the best interest of the investing and consuming public and the profession.
- instilling the desire to do the right thing and adhere to the standards set forth in the AICPA Code of Professional Conduct.

Accounting students should strive to be the best accounting professionals possible. To that end, we dedicate the book to instilling a sense of ethics and professionalism.

What's New in the 5th Edition?

In response to feedback and guidance from numerous accounting ethics faculty, the authors have made many important changes to the fifth edition of *Ethical Obligations and Decision Making in Accounting: Text and Cases,* including the following:

Connect

- **Connect is available** with assignable cases, test bank assessment material, and SmartBook. **SmartBook** is an excellent way to ensure that students are reading and understanding the basic concepts in the book and it prepares them to learn from classroom discussions. Several of the **Chapter Cases** are available in an auto-graded format to facilitate grading by instructors. The purpose of using the digital format is to better prepare students ahead of class to free up instructors to discuss a broader range of topics in their lectures and in the give-and-take between teacher and student. **Connect Insight Reports** will also give the instructor a better view into the overall class's understanding of core topics prior to class to appropriately focus lectures and discussion. The **Connect Library** also offers materials to support the efforts of first-time and seasoned instructors of accounting ethics, including a comprehensive Instructor's Manual, Test Bank, Additional Cases, and PowerPoint presentations.
- **Learning Objectives** have been added and linked to specific content material in each chapter.

End-of-Chapter Assignments

Each chapter includes 25 discussion questions (20 in chapter 8) that are designed to review important topics in the text with students and apply their knowledge to new situations. Ten cases (5 in chapter 8) cover a variety of topics deemed most important in each chapter. We have purposefully kept most of these cases short to provide ample time for discussion in class about the ethical issues and to not get too bogged down with financial analysis. However, we do provide many SEC cases that focus on the numbers and are more comprehensive. We hope the mixture will serve the interests of all instructors.

The major cases have been restructured in the fifth edition to provide a selection of short and long cases, all of which have one thing in common: through the questions at the end of each case students are given the opportunity to tie together important topics discussed in the text and apply their knowledge of ethical reasoning to more complex situations. We have included on the web some of the discussion questions, end-of-chapter cases, and major cases from the third and fourth editions not carried over to the fifth edition to make way for new cases and keep the book fresh and up to date. Instructors may find this material useful for assignment purposes. We have also revised and enhanced additional Instructor's Resource Materials and supplements.

Chapter-by-Chapter Enhancements

Chapter 1

- Expanded discussion of Egoism to include Ayn Rand's *Rational Egoism,* a method of ethical reasoning popular with today's young adults and millennials.
- **New** coverage of moral turpitude and other "Acts Discreditable to the Profession." Recent studies have indicated violations of this ethics rule by CPAs are on the rise because of DUI and other offenses. Additional concerns in this area may exist over time especially in those states that permit recreational use of cannabis.
- Expanded discussion of the Principles of the AICPA Code of Professional Conduct, the public interest obligation, and regulation in the accounting profession.

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Chapter 2

- **New** discussion of cognitive biases that can influence audit decision-making.
- **New** discussion of *equity, diversity, and inclusion.*
- Enhanced discussion of the GVV technique. Chapter 2 discusses the foundation of the approach including examples on applying the methodology. There are twenty cases in the book that apply GVV. These cases are designated as "a GVV case."
- Discussion of Volkswagen "Dieselgate" scandal.

Chapter 3

- Updated results from the Association of Certified Fraud Examiners Global Survey of Fraud.
- **New** discussion of corporate social responsibility including *sexual harassment.*
- Expanded discussion of the Sarbanes-Oxley Act and whistleblower protections.
- Expanded discussion of the Dodd-Frank Financial Reform Act and when to report financial wrongdoing to the SEC.
- Implications of the U.S. Supreme Court decision in *Digital Realty Trust, Inc. v. Somers* and how it may influence when would-be-whistleblowers inform the SEC of financial wrongdoing.
- Analyze when whistleblowers can use confidential company documents to expose fraud.
- Examine Equifax Data Breach in the context of corporate governance.

Chapter 4

- Enhanced discussion of professional judgment in accounting.
- Expanded coverage of KPMG Professional Judgment Framework.
- **New** discussion of problems for auditors who uncritically accept management's representations in an audit.
- Comprehensive discussion of the Revised AICPA Code of Professional Conduct including the threats and safeguards approach to determine when violations exist of independence, integrity and objectivity, and the presence of ethical conflicts.
- **New** discussion of confidentiality and disclosing fraud.
- Expanded discussion of ethics in tax practice.
- Discussion of recent cases brought against CPA firms for violating the AICPA Code.

Chapter 5

- Expanded discussion of errors, illegal acts, and fraud.
- Expanded discussion of Private Securities Litigation Reform Act and reporting requirements to the SEC; fraud and confidentiality issues explored.
- **New** Discussion of Professional Skepticism Scale that measures traits conducive to developing a questioning mind and informed judgment.
- Discussion of findings of the Center for Audit Quality of audit deficiencies.

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- Expanded discussion of PCAOB audit inspection process and high rate of deficiencies of audit firms.
- **New** requirements to disclose critical audit matters in the audit report.

Chapter 6

- **New** cases that explore in depth legal obligations of accountants and auditors.
- **New** discussion of audit malpractice.
- Expanded section on legal liabilities under Sarbanes-Oxley.
- Expanded discussion on regulatory issues and PCAOB inspections.
- **New** requirements under SSARS No. 21 for compilations and issuing non-compilation reports.
- Enhanced coverage of auditor liability for internal control over financial reporting.

Chapter 7

- **New** discussion of earnings guidance and forward-looking-statements.
- **New** discussion of SEC Regulation G and Item 10(e) of Regulation S-K that define a "non-GAAP financial measure" including Compliance and Disclosure guidelines.
- Expanded discussion of non-GAAP financial measures including EBITDA and other non-GAAP performance measures.
- **New** examples of GAAP to non-GAAP reconciliations.
- **New** examples of lack of professional judgment in critical areas of the audit and auditing estimates.
- Expanded discussion of the use of accruals and earnings management.
- **New** discussion of revenue recognition standard, *Revenue from Contracts with Customers*
- Detailed examples of financial statement restatements including Hertz Corporation.

Chapter 8

Chapter 8 links back to discussions in Chapters 1 through 7 by incorporating material on "Ethical Leadership." The purpose is to leave students with a positive message of the importance of being a leader and ethical leadership in building organizational ethics. Leadership in decision-making in accounting, auditing, tax, and advisory services engagements is addressed. If there is one theme that describes what this chapter is about it is: "Businesses don't fail; leaders do." The chapter includes the following major topics:

- **New** discussion of audit quality controls, audit leadership, and audit failures**.**
- Expanded discussion of professional role and leadership.
- Revisiting moral intensity in the context of ethical leadership.
- Expanded discussion of ethical leadership in the practice of public accounting.
- **New** case studies on ethical leadership.
- Implications of ethical leadership for whistleblowing activities.
- Ethical leadership and the GVV technique.
- Ethical leadership competence.

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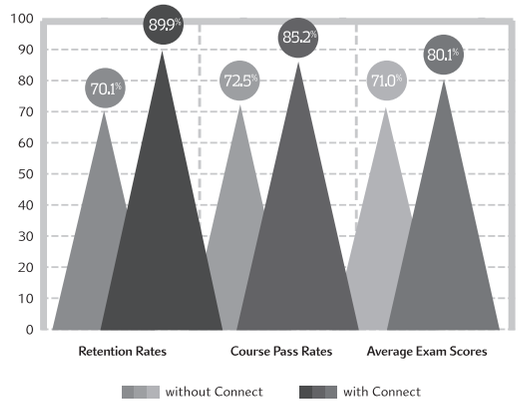

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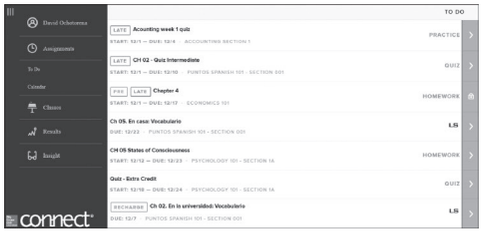

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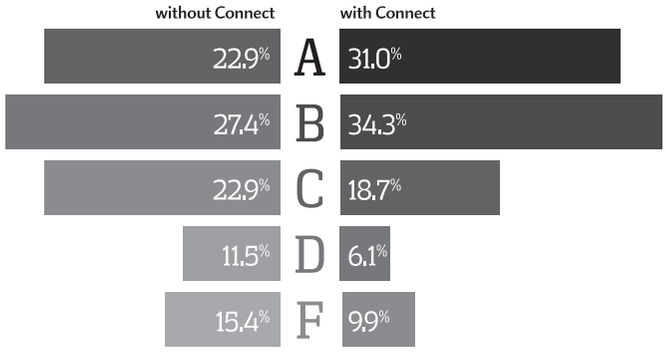

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If you have any questions, comments, or suggestions concerning *Ethical Obligations and Decision Making in Accounting,* please send them to Steve Mintz at smintz@calpoly.edu.

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Case Descriptions

Case #	Case Name/Description
1-1	**Harvard Cheating Scandal** *Student cheating at Harvard raises questions about responsibilities of instructors and personal responsibilities of students.*
1-2	**Giles and Regas** *Dating relationship between employees of a CPA firm jeopardizes completion of the audit.*
1-3	**Unintended Consequences** *Ethical dilemma of a student who accepts an offer of employment from a firm but, subsequently, receives additional, attractive offers from other firms.*
1-4	**Lone Star School District** *Failure to produce documents to support travel expenditures raises questions about the justifiability of reimbursement claims.*
1-5	**Moral Turpitude** *Accountant gets caught up in a police raid at a client's location and faces disciplinary action for committing an act discreditable to the profession.*
1-6	**Capitalization versus Expensing** *Ethical obligations of a controller when pressured by the CFO to capitalize costs that should be expensed.*
1-7	**Eating Time** *Ethical considerations of a new auditor who is asked to cut down on the amount of time that he takes to complete audit work.*
1-8	**Shifty Industries** *Depreciation calculations and cash outflow considerations in a tax engagement.*
1-9	**Cleveland Custom Cabinets** *Ethical and professional responsibilities of an accountant who is asked to "tweak" overhead to improve reported earnings.*
1-10	**Better Boston Beans** *Conflict between wanting to do the right thing and a confidentiality obligation to a coworker.*

Case #	Case Name/Description
2-1	**A Team Player? (a GVV case)** *Ethical dilemma for audit staff member who discovers a deficiency in inventory procedures but is unable to convince the group to report it.*
2-2	**FDA Liability Concerns (a GVV case)** *Conflict between a chef and CFO over reporting bacteria found in food and FDA inspection results.*
2-3	**Taxes and the Cannabis Business (a GVV case)** *Declaring the appropriate amount of sales revenue from cash transactions in the cannabis business and the impact on taxable income.*
2-4	**A Faulty Budget (a GVV case)** *Ethical and professional responsibilities of an accountant after discovering an error in his sales budget.*
2-5	**Gateway Hospital (a GVV case)** *Behavioral ethics considerations in developing a position on unsubstantiated expense reimbursement claims.*
2-6	**The Normalization of Unethical Behavior: The Harvey Weinstein Case** *Sexual harassment in the movie industry and the media and biases that influence whether such instances are reported.*
2-7	**Milton Manufacturing Company** *Dilemma for top management on how best to deal with a plant manager who violated company policy but at the same time saved it $1.5 million.*
2-8	**Juggyfroot (a GVV case)** *Pressure imposed by a CEO on external accountants to change financial statement classification of investments in securities to defer reporting a market loss in earnings.*
2-9	**Racially Charged Language Inhibits Inclusive Cultures** *Equity, diversity, and inclusion policies (EDI) on college campuses and biases and stereotypes.*

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2-10 WorldCom
Persistence of internal auditor Cynthia Cooper to correct accounting fraud and implications for Betty Vinson, a midlevel accountant, who went along with the fraud.

Case # Case Name/Description

3-1 The Parable of the Sadhu
Classic Harvard case about ethical dissonance and the disconnect between individual and group ethics.

3-2 Rite Aid Inventory Surplus Fraud
Dilemma of director of internal auditing whether to blow the whistle under Dodd-Frank on Rite Aid's inventory surplus sales/kickback scheme.

3-3 United Thermostatic Controls (a GVV case)
Acceptability of accelerating the recording of revenue to meet financial analysts' earnings estimates and increase bonus payments.

3-4 Franklin Industries' Whistleblowing (a GVV case)
Considerations of internal accountant how best to voice her values to convince others to act on questionable payments to a related-party entity.

3-5 Walmart Inventory Shrinkage (a GVV case)
Pressure to reduce inventory shrinkage at a Walmart store amidst alleged accounting improprieties and related efforts of the protagonist to voice values.

3-6 Full Disclosure: The Case of the Morally Challenged AP Clerk (a GVV case)
Implications of not reporting embezzlement by an employee to the police in light of the pending initial public offering.

3-7 Olympus
Major corporate scandal in Japan where Olympus committed a $1.7 billion fraud involving concealment of investment losses through fraudulent accounting.

3-8 Accountant takes on Halliburton and Wins!
Violation of confidentiality in a whistleblowing case under SOX after Tony Menendez reported accounting improprieties to the SEC and was retaliated against by Halliburton.

3-9 Loyalty to the Boss, Company, and/or the Profession: Whistleblowing as a Lever (a GVV case)
Improper capitalization of research and development costs and implications for meeting projected earnings per share.

3-10 Accountability of Ex-HP CEO in Conflict of Interest Charges
Sexual harassment charges stemming from conflict of interest between CEO/board chair and outside contractor.

Case # Case Name/Description

4-1 KBC Solutions
Concerns about professional judgments made by audit senior after the review of workpaper files.

4-2 Beauda Medical Center
Confidentiality obligation of an auditor to a client after discovering a defect in a product that may be purchased by a second client.

4-3 Family Games, Inc. (a GVV case)
Ethical dilemma for a controller being asked to backdate a revenue transaction to increase performance bonuses in order to cover the CEO's personal losses.

4-4 A Potential Threat to Professional Judgment?
Threats to professional judgment because of biased feelings towards client and potential influence on integrity and objectivity, professional skepticism, and independence.

4-5 Han, Kang & Lee, LLC (a GVV case)
Pressure between audit partner who wants the client to write down inventory and other partners that want to keep the client happy.

4-6 Tax Shelters
Ethical dilemma of tax accountant in deciding whether to participate in tax shelter transactions targeted to top management of a client entity in light of cultural influences within the firm.

4-7 Romance at EY Creates New Independence Policy
Threats to independence because of close relationship between EY partner and chief accounting officer of audit client.

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4-8 **Did the CPA Violate any Rules of Conduct?**
Failure of CPA to respond to state board of accountancy investigation into his performance of professional services for a payroll and tax client.

4-9 **Eminent Domain: Whose Rights Should be Protected?**
Enforceability of postemployment protective covenants not to compete based on reasonableness of restrictions.

4-10 **Navistar International**
Confidentiality issues that arise when Navistar management questions the competency of Deloitte & Touche auditors by referring to PCAOB inspection reports and fraud at the company.

Case # Case Name/Description

5-1 **Loyalty and Fraud Reporting (a GVV case)**
Employee who embezzles $50,000 seeks out the help of a friend to cover it up. Application of the fraud triangle and GVV.

5-2 **ZZZZ Best**
Fraudster Barry Minkow uses fictitious revenue transactions from nonexistent business to falsify financial statements.

5-3 **Reauditing Financial Statements**
Request to reaudit work of previous auditors.

5-4 **GE Multibillion Insurance Charge**
Threats to viability of insurance business after taking charges to earnings due to underestimating risk.

5-5 **Tax Inversion (a GVV case)**
Questions about the use of IFRS in a consolidation with an Irish entity motivated by tax inversion benefits.

5-6 **Rooster, Hen, Footer, and Burger**
Ethical obligations of a CPA following the discovery of an unreported related party transaction and push back by client entity.

5-7 **Diamond Foods: Accounting for Nuts**
Application of the fraud triangle to assess corporate culture and analysis of fraud detection procedures.

5-8 **Critical Audit Matters or Potentially Damaging Disclosure**
Determination whether to communicate critical audit matters to the audit committee.

5-9 **Weatherford International**
Auditors' failure to detect deceptive income tax accounting, even though client was included in a high-risk category, and restatement of financial statements.

5-10 **Groupon**
Competitive pressures on social media pioneer leads to internal control weakness and financial restatements.

Case # Case Name/Description

6-1 **Advanced Battery Technologies: Reverse Merger**
Application of legal standards to assess auditor liability following a reverse merger transaction by a Chinese company.

6-2 **Joker & Wild LLC**
Auditor acceptance of management misrepresentations and alleged malpractice.

6-3 **QSGI, Inc.**
Circumvention of internal controls by client management and false statement to auditors about operating effectiveness.

6-4 ***Anjoorian et al.*: Third-Party Liability**
Application of the foreseeability test, near-privity, and the Restatement approach in deciding negligence claims against the auditor.

6-5 ***Vertical Pharmaceuticals Inc. et al. v. Deloitte & Touche LLP***
Fiduciary duties and audit withdrawal considerations when suspecting fraud at a client.

6-6 **Kay & Lee LLP**
Auditor legal liability when foreseen third party relies on financial statement.

6-7 **TransWays' FCPA Dilemma (a GVV case)**
Assessing whether a payment to a foreign agent constitutes a facilitating payment or bribe under the Foreign Corrupt Practices Act.

6-8 **Disclosing Material Weaknesses in ICFR or Protecting the Firm from Litigation? (a GVV case)**
Identified material weaknesses in internal controls and disclosure in the audit report.

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6-9 ***Miller Energy Resources, Inc.***
PCAOB investigation of KPMG and an audit partner for conducting a materially deficient audit and related legal liability.

6-10 ***In re Puda Coal Securities***
Court opinion stating auditors' reports are opinions based on considerable subjective judgments and are not certifications.

Case # Case Name/Description

7-1 **Nortel Networks**
Use of reserves and revenue recognition techniques to manage earnings.

7-2 **Solutions Network, Inc. (a GVV case)**
Ethical challenges of a controller in voicing values when the company uses round-trip transactions to meet earnings targets.

7-3 **Allergan: Mind the GAP**
Disagreements with the SEC about presentation of non-GAAP metrics in financial reports and press releases.

7-4 **The Potential Darkside of Using Non-GAAP Metrics (a GVV case)**
Acceptability of presenting multiple non-GAAP measures to "better" explain financial results and provide useful information to users of financial reports.

7-5 **Dell Computer**
Use of "cookie-jar" reserves to smooth net income and meet financial analysts' earnings projections.

7-6 **TierOne Bank**
Failure of KPMG to exercise due care and proper professional judgment in gathering supporting evidence for loan loss estimates.

7-7 **Non-GAAP Metric Disclosure by General Electric: Value Added, Red Herring, or Red Flag?**
Confusing disclosures of non-GAAP metrics by GE and SEC comment letter about inconsistencies with GAAP and potentially misleading information.

7-8 **Monsanto Company Roundup**
Improper accounting for rebates offered to product distributors and retailers; auditing of restated financial statements.

7-9 **The North Face, Inc.**
Questions about revenue recognition on barter transactions and the role of Deloitte & Touche in its audit of the client.

7-10 **Beazer Homes**
Use of cookie jar reserves to manage earnings and meet EBIT targets.

Case # Case Name/Description

8-1 **Research Triangle Software Innovations (a GVV case)**
Advisory services staff member recommends the software package of an audit client to another client and deals with push back from her supervisor who is pushing the firm's package; issues related to leadership and application of GVV in resolving the matter.

8-2 **New Leadership at General Electric**
Discussions about corporate culture, leadership style, and disappointing operating results in conference calls with financial analysts and investors.

8-3 **KPMG Tax Shelter Scandal**
Major tax shelter scandal case involving KPMG that explores ethical standards in tax practice and in developing tax positions on tax shelter products in a culture that promoted making sales at all costs.

8-4 **Krispy Kreme Doughnuts, Inc.**
Questions about ethical leadership and corporate governance at Krispy Kreme, and audit by PwC, with respect to the company's use of round-trip transactions to inflate revenues and earnings to meet or exceed financial analysts' EPS guidance.

8-5 **Audit of Friars for Life**
Questionable decisions by auditors and client pressure that raises issues about future audits.

Major Cases: See this section at the back of the book for details.

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Chapter 2

Cognitive Processes and Ethical Decision Making in Accounting

Learning Objectives

After studying Chapter 2, you should be able to:

LO 2-1 Analyze the thought process involved in making decisions and taking ethical action.

LO 2-2 Explain how our thoughts might bias our decision-making process.

LO 2-3 Distinguish between equity, diversity, and inclusion.

LO 2-4 Describe Kohlberg's stages of moral development.

LO 2-5 Explain how cognitive processes influence ethical decision making in accounting.

LO 2-6 Explain Rest's model and how its components influence ethical decision making.

LO 2-7 Describe the link between moral intensity and ethical decision making.

LO 2-8 Explain how moral reasoning and virtue influence ethical decision making.

LO 2-9 Apply the steps in the Integrated Ethical Decision-Making Model to a case study.

LO 2-10 Describe the "Giving Voice to Values" technique and apply it to a case study.

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Ethics Reflection

Enron's Fall From Grace

During the courtroom testimony of Kenneth Lay, former CEO and chairman of the board of directors of Enron, and Jeff Skilling, former CEO of Enron, some observers were shocked that both seemed to believe Enron was a healthy company up to the bitter end. Instead, the company became the poster-child for failed companies during to financial frauds of the early 2000s because of the arrogance of its top leaders and failure to accept responsibility for their actions. Enron's use of a sophisticated tool to hide debt, "special-purpose entities," pushed the envelope on what is proper accounting. The financial institutions that got burned blamed Enron for their losses and wanted to teach the company a lesson.

Enron used special purpose entities to mask debt by borrowing money from financial institutions and transferring the debt to off-balance-sheet entities that were set up precisely for this reason. The goal was to make the company look like it was more financially sound than it really was. At the time, the accounting rules were unclear as to the treatment of such transfers and Enron took advantage of the 'gap' in GAAP.

Enron used this device to hide debt over and over again. By all accounts there were some 3,000 such entities. Ultimately, the banks grew weary of helping to set up these entities and the questionable collateral for the debt. By the time Enron declared bankruptcy in January 2002, the company had $13.1 billion in debt on its books; $18.1 billion on its nonconsolidated subsidiaries' books; and an estimated $20 billion more off the balance sheets. Its stock price had gone from $90.75 per share on December 2, 2001, before it declared bankruptcy, to $0.67 by January 2002.

Enron was "creative" with its accounting for long-term investments. Mark-to-market is a technique used to value investments and was designed under GAAP to cover investments in marketable securities (e.g. stocks and bonds). Andy Fastow, the former CFO and mastermind of the fraud, used mark-to-market to value long-term contracts to provide power out of a new power plant still under construction. The company would immediately record all profits estimated to be made under the contract. The problem was that Enron created the market used to value its assets. Moreover, if the revenue from the power plant was less than the projected amount, instead of taking the loss the company would then transfer these assets to its off-balance-sheet entities, where the loss would go unreported.

According to the exposé of the Enron fraud by Bethany McLean and Peter Elkind, *The Smartest Guys in the Room,*[1] Lay and Skilling truly believed they had done nothing wrong. They were the victim of circumstances. In reality, they suffered from what has been called "moral blindness," or the state of unawareness or insensibility to moral issues both in oneself and to one's relations with others.

Another way to explain the behavior of Lay and Skilling is they had what Bazerman and Tenbrunsel calls "ethical blind spots"[2] where decision making was concerned. Ethical blind spots often obscure important aspects of a decision. Lay and Skilling didn't realize their decisions had ethical implications and made unethical choices without knowing it.

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They didn't know or didn't care that their actions would have consequences for themselves, the company, employees, and shareholders. Their decisions were based on an end justifies the means approach. The company's end goal was to become the largest natural gas and utility company in the world. It didn't matter how it got there; just that it did.

We can also look at decision making at Enron through the lens of cognitive biases. A cognitive bias refers to a systematic pattern of deviation from norms or rationality in judgment that manifests itself as a mistake in reasoning, evaluating, reflecting, and other cognitive processes. Individuals create their own social reality from their perception of the input rather than an objective analysis of it.[3] Cognitive biases can fool an individual into thinking, depending on how an issue is framed, that one is not even facing a moral or ethical dilemma.[4]

Andy Fastow made a presentation about the fraud on April 6, 2016, and he explained the rationalizations Enron used for its improper actions.[5]

- Helping the company and its shareholders by increasing profits and stock price.
- Timing problem or "We'll grow out of it."
- Immaterial amounts.
- Rewarded and recognized behavior by the company.
- Systemic problem.
- It has been approved. I'm following the rules.

Fastow was correct in that the accounting was approved by Andersen, the now defunct auditors of Enron, and the company's board of directors. How could this be? Well, the board was under the control of Lay and Skilling, who benefited the most from the fraud. Others weren't about to say anything: the top five executives at Enron received payments of $282.7 million in the year 2000 alone. Of this amount, Lay received $67.4 million and Skilling, $41.8 million.

Think about the following as you read the chapter: (1) How can cognitive biases influence your decision making? (2) What would you do if your attitudes and beliefs about right and wrong are being tested by pressures within an organization? (3) How can you counteract the reasons and rationalizations given to you to go along with manipulated financial statements?

As we practice resolving dilemmas we find ethics to be less a goal than a pathway, less a destination than a trip, less an inoculation than a process.

Source: Ethicist Rushworth Kidder (1944–2012)

Kidder believed that self-reflection was the key to resolving ethical dilemmas, and a conscious sense of vision and deep core of ethical values provide the courage to stand up to the tough choices. The pathway one takes can be influenced by biases we have about ourselves and others that need to be understood and acted upon to successfully continue the journey to ethical decision making.

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Behavioral Ethics

LO 2-1

Analyze the thought process involved in making decisions and taking ethical action.

The field of behavioral ethics emphasizes the need to consider how individuals actually make decisions, rather than how they would make decisions in an ideal world. Knowledge of behavioral ethics is important to understand the way individuals think and process information, and how they deal with biases that can influence ethical decision making.

System 1 versus System 2 Thinking

Research in behavioral ethics reveals that our minds have two distinct modes of decision making— "System 1" and "System 2" thinking.[6] Daniel Kahneman, the Nobel Prize–winning behavioral economist, points out that System 1 thinking is our intuitive system of processing information: fast, automatic, effortless, and emotional decision processes; on the other hand, System 2 thinking is slower, conscious, effortful, explicit, and a more reasoned decision process. Walter points out that the dominant role of System 1 in ethical decision making is evidenced by the fact that children, even babies, have a basic moral sense that is ingrained into their brains before they are taught morality by their parents and society.[7] For example, infants at the earliest levels of moral development in Kohlberg's model, discussed later, are aware of the importance of rules and the need to yield to authority figures.

Kahneman's fundamental proposition is that we identify with System 2, "*the conscious, reasoning self that has beliefs, makes choices and decides what to think about and what to do."* But the one that is really in charge is System 1 as it *"effortlessly originates impressions and feelings that are the main sources of the explicit beliefs and deliberate choices of System 2."*[8]

What follows is an example of using System 1 thinking instead of the more deliberate approach of System 2, and drawing the wrong conclusion as a result. To illustrate, answer the following question: A baseball bat and ball together cost $110. If the bat costs $100 more than the ball, how much does the ball cost? Most people say $10. They decide quickly, without doing the math or thinking through the question. However, it is the wrong answer. The ball actually cost $5, and the bat cost $105.

The broader point of this exercise is to explain how System 1 thinking can lead to snap decisions that make it more difficult to resolve an ethical dilemma in a morally appropriate way. It may occur because you lack important information regarding a decision, fail to notice available information, or face time and cost constraints. You don't have the time or inclination and fail to see the dangers of deciding too quickly.

Many decisions in business and accounting have ethical challenges. This is because of the impacts of those decisions and the fact that outcomes are likely to affect stakeholders in different ways and will express different ethical values. A decision-making model built on System 2 thinking can provide a more systematic analysis that enables comprehensible judgment, clearer reasons, and a more justifiable and defensible action than otherwise would have been the case.

Cognitive Errors

Some people do not make decisions as we might expect of a rational actor because rules of thumb and biases shape people's ethical decision making in ways they often do not understand or notice. Kahneman and Tversky point out that incrementalism (the slippery slope) may influence the behavior of even

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well-intentioned people who find themselves in situations in which ethical corners are being cut. It can be difficult to notice gradual changes in one's environment so that cutting corners grow until violations of the law occur.[9]

A good example of a cognitive error brought on by incrementalism is the case of Aaron Beam, the first CFO at HealthSouth Corporation, a company that had a $2.7 million accounting fraud in the 1990s. One day in 1996 the time came when the company couldn't make its projected earnings and CEO Richard Scrushy refused to report a bad quarter. Instead, he instructed the chief accountant to scatter false assets and revenues throughout the company's 1,500 ledgers to hit their targets. Beam watched this go on for a year before he decided to quit.[10] He was sentenced to three months in prison after pleading guilty to going along with the fraud out of fear of what the CEO, Richard Scrushy, might do if he did not agree.

Beam didn't notice the gradual changes in the health care environment brought on by increased competition and a slowing economy. He never considered that Scrushy would continue to pressure him to manipulate the numbers. Beam suddenly realized he had begun the slide down the slippery slope of reporting false numbers and the need to cover them up, and there was no turning back.

Some people fall victim to self-serving biases in their decision making whereby they tend to gather, process, and even remember information in a way that advances their perceived self-interest and to support preexisting views. People can readily notice how the self-serving bias might affect others' decisions on ethical matters, but they are often nearly blind in perceiving how they themselves might be affected. This kind of ethical blindness occurs because we fail to perceive or think about the ethical issues and contextual factors blinds us to right and wrong, such as occurred for Aaron Beam.

Drumwright et al. identify four additional cognitive shortcomings:[11]

- *The Tangible & the Abstract.* When people make ethically tinged decisions, they tend to consider immediate and tangible factors at the expense of more removed and abstract factors[12] (i.e., System 1 thinking).
- *Loss Aversion.* People have a tendency to detest losses even more than they enjoy gains so that they make more immoral decisions to avoid what they perceive to be a potential loss.[13]
- *Framing.* People have a tendency to make different decisions based upon how a question is framed so that other factors are framed as more important than ethical standards[14] (i.e., meet or beat financial statement earnings goals).
- *Overconfidence.* People have a tendency to believe that they are more ethical than they actually are, which can cause them to make decisions with serious ethical implications without proper reflection.[15]

Framing was an important factor in the Enron case. Top executives were fixated on share price, which caused them to focus on earnings projections. Knowing that missing earnings targets would lead to a steep reduction in share price, they engaged in accounting maneuvers to keep the stock price up. Ethical considerations were completely disregarded, despite Enron's code of ethics. Had the company's officers managed to keep ethics in their decision analysis, they might have acted differently.[16]

Social and Organizational Pressures

Matousek identifies two of the most common social and organizational pressures that can cause well-intentioned people to make poor ethical choices: the tendencies to be overly obedient to authority and to conform excessively to the ethical judgments and actions of peers. In accounting, it is important to follow superiors' instructions, especially if they are seen as being ethical.[17] However, the desire to please authority can bias one's outlook on a financial reporting issue, suspend one's own ethical judgment about right versus wrong, and bend to the wishes of a superior. Despite sensing she was being asked to do

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something wrong by WorldCom's CFO, Scott Sullivan, Betty Vinson rationalized that since he was the CFO, Sullivan must know better than herself what was the proper accounting.

Situational Factors

Situational factors can influence ethical decision making and the actor may not even be aware of the effect. Studies show that when people are under time pressure, they will often act less ethically than in situations when they are not. They will not realize the impact that time pressure has on their decision making and actions, but the impact is still there.[18] For example, a lead engagement auditor might be hustling to complete an audit on time and under budget and not realize certain steps in the audit process have not been properly completed.

Transparency is another important factor. Novelist C. S. Lewis famously said: "Integrity is doing the right thing, even when no one is watching." Research shows that if people feel that they are not being watched, they will tend to act less ethically.[19] A greater number of people will try to get away with wrongdoing if they feel they won't get caught. It's logical to conclude that the accounting frauds that took place in the late 1990s and early 2000s were masterminded by people who never thought they would be caught doing the deed. Bernie Madoff most likely would not have conned his investors out of $65 billion using a Ponzi scheme if he thought he was being watched by the authorities.

Cognitive Dissonance

One limitation of the philosophical reasoning approaches incorporated into decision-making models is that how we think we should behave is different from how we decide to behave. This creates a problem of *cognitive dissonance,* a term first coined by Leon Festinger in 1956. The inconsistency between our thoughts, beliefs, or attitudes and our behavior creates the need to resolve contradictory or conflicting beliefs, values, and perceptions.[20] Tompkins and Lawley point out that:

> This dissonance only occurs when we are "attached" to our attitudes or beliefs, i.e., they have emotional significance or consequences for our self-concept or sense of coherence about how the world works. The psychological opposition of irreconcilable ideas (cognitions) held simultaneously by one individual, create[s] a motivated force that [c]ould lead, under proper conditions, to the adjustment of one's beliefs to fit one's behavior instead of changing one's behavior to fit one's beliefs (the sequence conventionally assumed).[21]

Cognitive dissonance suggests that we have an inner drive to hold all our attitudes and beliefs in harmony and avoid disharmony. When there is inconsistency between attitudes or behaviors (dissonance), something must change to eliminate the dissonance. Festinger posits that dissonance can be reduced in one of three ways: (1) change one or more of the attitudes, behavior, or beliefs so as to make the relationship between the two elements a consonant one; (2) acquire new information that outweighs the dissonant beliefs; or (3) reduce the importance of the cognitions (beliefs, attitudes).[22]

The Betty Vinson situation illustrates the dangers of reducing dissonance by changing one's attitudes and behaviors. It also illustrates how situational factors and social and organizational pressures can create biased behavior. Vinson knew it was wrong to "cook the books." She felt it in her inner being, but she did not act on those beliefs. Instead, she followed the orders from superiors and later justified her behavior by rationalizing it as a one-time act and demanded by people who knew accounting better than herself. In a sense, she reduced the importance of her own intuitions about the appropriateness of what she was asked to do.

Bazerman and Gino ask: What makes even good people cross ethical boundaries?[23] Wittmer asks: Do individuals in organizations always act and behave consistently with what they know or believe to be the

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right thing to do?[24] The behavioral approach to ethics leads to understanding and explaining moral and immoral behavior in systematic ways. In reality, whether behaviors are viewed legally or ethically, we hold individuals accountable for their behaviors and choices, at least in part because they *should have* known better. Even if we agree on what someone should ethically do in a given situation, our judgment is often clouded by other factors that cause us to act against our intuition of what good sense dictates.

Why did CEO Richard Scrushy certify HealthSouth Corporation's financial statements when he knew or was reckless in not knowing they were materially false and misleading? What influenced him to behave unethically? Once we start asking these questions, we shift our attention from inquiring about what the right thing to do is, or what a good person should do. Rather, we are attempting to understand why such an individual acted the way he did, trying to identify the factors that influenced or caused the behaviors. We have moved from a prescriptive framework, such as with the philosophical reasoning methods, to a more descriptive mode of analysis. Such a perspective is important in leading organizations toward more ethical behavior.[25] It requires identifying levers at both the individual and the institutional level to change ethically questionable behaviors when individuals are acting in unethical ways that they would not endorse with greater reflection.[26]

Cognitive Biases

LO 2-2

Explain how our thoughts might bias our decision-making process.

Understanding the unconscious biases that people may have is an important first step to preventing unethical behavior. Messick and Bazerman believe that we have cognitive biases about the world, other people, and ourselves which can negatively influence our decision-making process. Understanding our own biases, and those of others, can help us avoid them and improve our ethical decision making.[27]

The biases identified above are often compounded by the false belief that the world is more deterministic (controllable) than it is. This illusion of control causes us to underestimate the risks involved with our decisions. Memories of past-experiences change to support this erroneous belief. A hindsight bias might develop where people tend to believe that they expected a past outcome before it occurred (even when they did not).

Theories about the world also suggest that we tend to blame individuals for events, rather than their work environment, policies and procedures, or incentive programs. This often leads to problems being framed inaccurately and can result in decisions which do not correct and may exacerbate the problem. Therefore, it is important to take time determining how a problem is framed in order to maximize the probability of finding a solution for it.

Theories About the World

According to Messick and Bazerman people have a tendency to simplify complex issues to make decision making easier. This can lead to underestimating risk and making poor decisions by ignoring low-probability events; failing to identify all stakeholders impacted; ignoring the possibility the public will find out; not thinking about long-term consequences; and undervaluing the magnitude of the consequences in total.[28]

A good example of the damage underestimating risk can have is the "Dieselgate" scandal at Volkswagen (VW). The scandal broke in July 2015 when the California Air Resources Board (CARB) shared its findings

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about carbon dioxide emissions from diesel vehicles produced by VW. CARB and the Environmental Protection Agency (EPA) refused to certify VW's 2016 diesel vehicles. VW at first blamed software irregularities. An increasing number of negative reports about VW's diesel vehicles and VW's culpability led to the auto company's admission in September 2015 that the cars were "designed and manufactured with a defeat device to bypass, defeat or render inoperative elements of the vehicles emission control system." The system was set to report levels of emission that would pass lab tests, even though they emitted as much as 40 times the legal limit of pollutants on the road.[29] Exhibit 2.1 elaborates on the facts of the case and legal liabilities.

As the criminal case against VW closed on April 4, 2017, many wondered who blew the whistle and first admitted to regulators that VW was lying about its dirty diesels? It was first reported in the book *Faster, Higher, Farther: The Volkswagen Scandal* by Jack Ewing, that an American engineer, Stuart Johnson, the head of VW's Engineering and Environmental Office which has responsibility for VW's interaction with U.S. regulators, was the first person to reveal to CARB the existence of VW's defeat device software.[30]

In March 2016, it was announced that Daniel Donovan, a former worker in VW's information technology group, alleged VW illegally destroyed electronic data in the days after the EPA publicly accused the company of cheating emissions tests by manipulating its vehicles' software. Donovan claimed he was fired for refusing to participate in destroying evidence and obstructing justice. He said the company violated its obligation to preserve evidence while under investigation and also kept documents from an outside accounting firm conducting an investigation.

VW's violation of just about every ethical standard portrays a company that ignored its own research and testing findings, covered-up the problem, lied to authorities, and failed to consider how its deceptive tactics would affect the driving public.

An interesting aspect of the case is VW's thought process in determining whether to fix the problem or hide it from the government. The company's cognitive shortcomings include miscalculating the consequences of not fixing the software problem. It began when the executives evaluated the costs to the company if they were caught. Reviewing previous cases of violations of environmental regulations by auto manufacturers in the U.S., they predicted that the likely fines posed "only a moderate cost risk." They cited the highest fine, imposed against Hyundai/Kia as amounting to "barely $91 per vehicle" and added, "fines in this amount are not even remotely capable of influencing the share price of a globally operative company such as Volkswagen."[31]

An independent analysis of VW's risk assessment shows that the company underestimated the risk of deliberately misleading regulators and the public. The company's error in reasoning was due to a belief that its chances of getting caught were slim, and even if it were caught, the size of the penalty would be manageable. Using numbers provided by the EPA and U.S. Justice Department, historically, the financial penalties imposed for Clean Air Act violations were in the range of about $96 to $292 per vehicle. These amounts were well below the maximum allowable of $37,500 per vehicle. The VW settlement called for a penalty of $29,000 per vehicle, well above previous settlements.[32]

VW significantly underestimated the risk of getting caught and resulting financial penalty if it did, which is why a cost-benefit analysis is risky. The company did not account for added costs because of the government's desire to teach the company a lesson. In imposing such a harsh penalty, the government indicated that not only was the magnitude of the excess emissions 40 times the legal limit, VW was also guilty of false advertising about their diesel engines. This was not an innocent mistake. It was a calculated attempt by VW management to get away with a wrongdoing, knowing that the wrongdoing existed, because it did not want to tarnish its image and figured it would be less expensive just to deal with any fines that might come its way.

Top management seemed indifferent to what was going on. Martin Winterkorn, the former CEO of VW, reacted to the scandal by blaming others. His reasoning process was influenced by a self-serving bias. He claimed he would have stopped the scandal had he known about it. In testimony before the *Bundestag,* Germany's Parliament, Winterkorn said he was "no software engineer and that the rogue acts didn't

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rise to his level." There were, however, indications that he may have missed the signs before the crisis erupted in public. VW said Winterkorn had received two memos informing him of discrepancies in U.S. diesel emissions in 2014 and that he participated in a meeting in July 2015 that touched on the matter. Winterkorn seems to have turned a blind eye to the warnings signs and may have fallen victim to how the issue was framed; those most responsible for the software problem focused more on the compliance issues and not enough on the ethical issues.[33]

VW was guilty of having a blind spot where ethics was concerned. Its management was overconfident about the company's ability to absorb losses. Its destruction of documents reflected a systemic problem fuelled by a lack of accountability and an organization that operated under an ends justifies the means approach to decision making. At the end of the day, VW's behavior tarnished the trust of the driving public and the company paid dearly for its lapse in judgment.

EXHIBIT 2.1 Volkswagen "Dieselgate" Scandal

The VW scandal began well-before the California Air Resources Board shared its results about software irregularities in VW diesel vehicles. In May 2014, researchers at West Virginia University and the International Council on Clean Transportation published findings that the 2012 VW Jetta TDI and 2013 Passat TDI had "significantly higher in-use emissions" in testing.[34] The Board tested updated emissions one year later and found some improvement, but not enough. That led to VW's admission and the beginning of a legal nightmare for the company that will probably end with close to a $25 billion payout for providing false information to the U.S. government about emissions and reimbursements to owners of the affected vehicles, far above the initial $14.7 billion estimate by VW.

Up to $10 billion of the projected $25 billion settlement were scheduled to be paid out to owners of the 487,000 affected diesel cars in the U.S., sold under the VW or luxury Audi brands. The owners had a choice to make: have VW fix the car or buy it back. 97.5% of Volkswagen diesel owners chose buyback, not repair.

Repurchasing the cars cost VW between $12,500 to $44,000 per car. The $14.7 billion estimated settlement assumed that all the cars would be repurchased. Owners who got their vehicles fixed will also receive a cash payment of between $5,100 and $10,000 to compensate them for the lost value of the cars, as well as for Volkswagen's deceptive promise of "clean diesel." Most of the buyers paid extra for a car with a diesel engine.

Two VW employees were given prison terms for their involvement in the VW scandal. Oliver Schmidt, the man who was in charge of VW's U.S. environmental and engineering office before the Dieselgate scandal, was sentenced to seven years in prison on December 6, 2017. Schmidt also pleaded guilty to violating the Clean Air Act and conspiracy to defraud the U.S. government for his role in VW's developing software to hide the fact that many of its cars were not meeting emission standards.

James Liang, a former VW engineer, was sentenced on August 25, 2017, to 40 months in prison and a $200,000 fine for his role in not reporting VW's use of software to cheat U.S. emission rules on nearly 600,000 diesel vehicles. Daniel Nixon, Liang's lawyer, said his client was not "greedy or immoral," but followed orders to keep his job and support his family. "What occurred here was wrong," Nixon said. "But he wasn't the mastermind. He was not motivated by greed."[35] It is interesting to note Nixon's "just following orders" defense, which is nothing more than a rationalization for unethical actions.

Theories About Other People

Business today operates in a global environment rich in diversity with people who speak different languages, have different customs, mores, cultural beliefs, religious beliefs, laws, and accepted ways of

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behavior. Unfortunately, people have a tendency to think of themselves and the groups they belong to or share their beliefs with as better than those they don't belong to whether based on factors of race, religion, nationality, political affiliation, and so on.

This perception that "our way" is normal and preferred and that other ways are somehow inferior has been called ethnocentrism. In the ethnocentric view, the world revolves around our group, and our values and beliefs become the standard against which to judge the rest of the world.

Ethnocentrism is best described an 'us versus them' mentality that is pervasive in most societies. Having national pride or being affiliated with a religious group is natural and there is nothing wrong with that. The problem lies in our tendency to inaccurately believe that our group is better than any other without taking the time to thoroughly analyze whether these beliefs are valid.

In business, these unconscious beliefs can manifest themselves through discriminatory hiring and promotion practices and favoritism for white employees over employees of color and men over women. Understanding the role that stereotypes can play in our decision-making process is critical if we hope to avoid their negative manifestations. It is essential, in an increasingly diverse workforce, to mold individuals with these differences into a coherent whole. This is the essence of ethical leadership.

Theories About Ourselves

Some people develop a hindsight bias, believing they are more capable than they actually are. We have a tendency to overestimate our positive attributes and to underestimate our weaknesses. A hindsight bias may creep up where people have the tendency to view events as more predictable than they really are. This can create a superiority bias whereby executives become overconfident in their abilities and make decisions based on incomplete or inaccurate information. The best decisions surrounding complex matters are made through consultation and inclusion of other points of view.

Overconfidence bias is important in accounting because auditors overconfident in their (conservative) risk assessments about certain areas of the audit (i.e., the risk of failure of internal controls) may fail to seek additional information to update their knowledge. One cost of overconfidence is a reluctance to learn more about how the internal controls work before determining whether they are working as intended.[36]

Asch found that people have a tendency to yield to group pressure, even when they know the majority view is incorrect. The greater the number of people in the majority, the more likely those in the minority change their view to conform with the majority. "Group Think" speaks to an unconscious need for approval and avoidance of conflict within the groups we belong. This bias can result in individual group members not sharing concerns they may have about potential consequences a decision may have, leading to poor decisions being made.[37]

Stanley Milgram's classic 1963 study involving a persons' willingness to administer increasingly more severe electrical shocks to others as punishment demonstrates our tendency to subjugate our will to authoritative figures. The experiment shows that people have a tendency to follow the instructions of those they perceive to be in authority, even when those instructions conflict with their own values.[38] This bias can result in a person unconsciously giving more weight to their loyalty to their employer than their own integrity when making a decision as to whether to go along with an unethical request made by that employer.

Obedience to authority played a role in the Enron case. Andy Fastow and David Duncan, the Andersen auditor who went along with Enron's improper accounting, explicitly raised the defense that they were just following orders. In fact, this was the rallying cry for many in the era of financial frauds at companies such as WorldCom (Betty Vinson) and other leading figures in the Enron-era scandals.[39]

Our awareness of situations that create bias is important in the audit function. Auditors need to understand how they might utilize their understanding of biases to improve their ethical decision making. We

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build on our discussion of biases in this chapter in Chapter 4 where we discuss the link between KPMG's Professional Judgment Framework and our cognitive processes.

Bystander Effect

People also have a tendency to not report incidents of wrong doing they may witness if they believe (or hope) others will report it. Each individual may think that others will come to the aid of the threatened person. This bias is known as the bystander effect. Studies have shown that the greater the number of people present, the fewer the incidents of assistance; we take our cues from the behavior of others, and that is, after all, less stress and hassle to ourselves to assume others will intervene.[40]

One example of the bystander effect at work is an incident that occurred on a subway platform in New York City on December 3, 2012. During a disagreement between two passengers waiting for the train, Ki-Suck Han was pushed off the platform by Naeem Davis. Han was killed by an oncoming train while observers did nothing to help him off the tracks. One such observer, R. Umar Abbasi, a freelance photographer, took pictures of the incident. When questioned, Abbasi said he was shocked that people nearer to Han didn't try to help in the 22 seconds before the train struck. He figured others were closer and could have grabbed him and pulled him to safety.

Another example of the bystander effect is the rash of sexual harassment charges during 2017, first against Hollywood moguls such as Harvey Weinstein, then media personalities like Matt Lauer, and finally, a large number of Congressmen, many of whom resigned, including Minnesota Senator Al Franken. In each of these cases, the women alleging sexual harassment did not come forward initially because they feared for their career. Moreover, consciously or unconsciously, they assumed others similarly affected would report the wrongdoing.

The bystander effect could manifest itself in accounting if a fraud occurs and those in the know don't report it believing others, such as higher-ups, would do so. Failing to report fraud violates the integrity principle in the AICPA Code. An accountant or auditor cannot turn a blind eye to wrongdoing that affects the accuracy and reliability of the financial statements.

Equity, Diversity, and Inclusion

LO 2-3

Distinguish between equity, diversity, and inclusion.

We hear a lot about equity these days. It tends to be thought of as one of three key values necessary in the 21st century workplace. Equity, Diversity, and Inclusion (EDI) loosely means to give each person the same opportunity, accepting people from different races, genders, religions, and nationalities, and inviting those who have been historically locked-out of society to come in. EDI policies should promote ethical behavior and tear down biases that might influence the fair treatment of all people.

Diversity versus Inclusion

Diversity and inclusion are often viewed the same way. However, there are important differences. The U.S. government's Office of Personnel Management indicates that diversity is hiring and retaining employees that "reflect America's diversity," while inclusion is making them feel motivated, and a true part of the organization.[41]

The concept of diversity encompasses acceptance and respect. It means to treat each person as unique and to recognize our individual differences. It means understanding each other and moving beyond simple

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tolerance to embracing and to celebrating the rich dimensions of individuality. A diverse workforce is one where similarities and differences among employees in terms of different dimensions are molded together to produce the best outcome.

Inclusion has often been defined in the context of a society that leaves no one behind. It is one in which the cultural, economic, political, and social life of all individuals and groups can take part. The United Nations report, *Creating an Inclusive Society: Practical Strategies to Promote Social Integration,* points out: An inclusive society is one that overrides differences of race, gender, class, generation, and geography, and ensures inclusion and equality of opportunity, as well as capability of all members of the society to determine an agreed set of social institutions that govern social interaction.[42]

Equality vs. Equity

People tend to think about equality of opportunity and fairness in treatment as one and the same. It means having the same rights, social status, etc. Equality aims to ensure that everyone gets the same things in order to enjoy full, healthy lives. Like equity, equality aims to promote fairness and justice, but it can only work if everyone starts from the same place and needs the same things. But when we place it next to equity, that's when the lines get blurred. Equity can be thought of in terms of equal opportunity that fit a person's circumstances and abilities. It may mean giving a group of people different access to resources, as with disabled individuals who deserve special access for entry or different testing procedures in the classroom. In the workplace, it means to provide accommodations as needed.

A good analogy is to think of runners sprinting around an oval track during a competition. The concept of equality would mean treating runners the same way; having them start at the same place on the track. While this may seem fair at first, we quickly realize that those starting from an inside position have an advantage over runners in the outside lanes because the distance they have to travel is shorter. As a result, equality – starting at the same place – doesn't result in fairness. The concept of equity would mean the starting positions should be staggered so runners in the outer lanes have an equal chance to win the competition. In this case, different or tailored treatment leads to fairness and justice, not the same treatment.[43]

Deloitte Surveys

EDI policies are an integral part of ethics because the way we treat people with different demographic characteristics says a lot about the culture of an organization. The underlying principles of fairness and justice provide the foundation for EDI policies. The virtues of caring, kindness, and empathy should drive behavior in an ethical organization that wants to be known as a welcoming and supportive place to work.

According to the Deloitte survey, *Global Human Capital Trends,* 69% of executives rate diversity and inclusion an important issue, up from 59% in 2014.[44] Why has diversity and inclusion become so important? One answer is, in today's global business environment, it is common to have a diverse workforce that needs to be managed in ways that recognize equity and fairness in treatment. A diverse workforce poses challenges in the way people of different religions, genders, generations, and other types of diversity blend together to create an ethical corporate culture that values individuals from many walks of life.

The Deloitte survey indicates that 78% of respondents believe diversity and inclusion is a competitive advantage. Yet, despite this increased level of interest, only six percent of companies actually tie compensation to diversity outcomes. Solving diversity challenges is very difficult. Also, trending upward is a focus on eliminating measurable bias from talent processes, including hiring, promotion, performance management, leadership development, succession, and compensation.

In another survey by Deloitte – the *Inclusion Pulse Survey* – it was found that 72% of working Americans surveyed would or may consider leaving an organization for one they think is more inclusive. Thirty percent of millennials surveyed say they have already left a job for one with a more inclusive culture.[45]

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The Deloitte Pulse survey gathered online responses during April 13-20, 2017, from more than 1,300 full-time employees from different sized companies across the U.S. The survey reported that inclusivity was perceived differently by different groups, but when it comes to workplace culture, most respondents relate more to the way inclusion "feels" over how it may "look." Nearly half of all respondents (47%) chose "an environment that makes me feel comfortable being myself" as one of the top three attributes of an inclusive workplace.

Why the differences? One reason is different definitions of inclusion create different perceptions of what it is and could be. Here are four definitions cited in the survey.

Inclusion: Respect for and appreciation of differences in demographic characteristics such as race, ethnicity, gender, age, national origin, disability, sexual orientation, and/or non-demographic characteristics such as religion, experiences, communication style, or work habits.

Stereotype-biased bias: Attitudes or generalized beliefs about people that affect understanding, actions, and decisions, such as assuming one group of people are more intelligent or hard working than other groups.

Inclusive: Embracing all people; making all people feel valued and they belong in their organization.

Inclusion initiatives: Efforts to help all people feel that they are valued and belong in their organization.

EDI policies are significantly more important in the 21st century than ever before. One reason is young adults and millennials have grown up in a culture that talks about these issues even though they may be lacking in reality. The expectations are high for an inclusive environment and the failure to do so can have negative consequences as the survey results indicate.

Deloitte's 2017 *Global Human Capital Trends* survey reports that diversity and inclusion at the workplace are now CEO-level issues, but they continue to be frustrating for many companies.

Sexual Harassment

Issues of equality, equity, and fairness are front and center when men (or women) with power and influence use their positions to extract favors from subordinates of the same or other sex. The allegations of sexual harassment and its relation to the bystander effect illustrates an environment where treating women (or men) equally might be dependent on whether they are willing to accept sexual overtones and other forms of threatening behavior.

Sexual harassment oftentimes implies a "quid pro quo"—something for something. A harassed woman may come to believe that her boss could stifle her career advancement unless she tolerates such behavior . . . and maybe more.

Sexual harassment is unwelcome behavior of a sexual nature that is severe, pervasive, or persistent enough to create a hostile or intimidating work environment. It can include physical touching, verbal comments, non-verbal conduct such as leering or emails, or a combination of these things.

As far as biases go, harassing behavior can create the belief that the recipient will not be treated equally and have the same opportunities unless they give in to sexual advances.

Uber Sexual Harassment Case

Charges of sexual harassment lodged against Uber by Susan Fowler in 2017 led to an investigation of the company's practices and corporate culture. Fowler's blog post, "Reflecting on one very, very strange year at Uber," detailed allegations of harassment, discrimination, and retaliation during her employment at Uber, and the ineffectiveness of the then-existing policies and procedures. Exhibit 2.2 provides details of

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Fowler's experiences and the role and responsibilities of the Covington law firm that investigated these practices and their recommendations in general.

Covington was instructed to evaluate three issues: (1) Uber's workplace environment as it related to the allegations of discrimination, harassment, and retaliation in Fowler's post; (2) whether the company's policies and practices were sufficient to prevent and properly address discrimination, harassment, and retaliation in the workplace; and (3) what steps Uber could take to ensure that its commitment to a diverse and inclusive workplace was reflected not only in the company's policies but made real in the experiences of each of Uber's employees.

The recommendations for Uber were numerous and covered areas such as changing senior leadership and board oversight to develop and oversee diversity and inclusion policies, strengthening internal controls, reformulating Uber's cultural values, mandatory training for managerial personnel and the human resources department, diversity and inclusion enhancements in recruiting women and other underrepresented minority groups, providing an effective complaint process, recognizing and supporting efforts of employees to improve the workplace environment, and eliminating bias and misuse of the performance evaluation system.

The following specific recommendations illustrate the extensive steps Uber pledged to take in accepting the recommendations of the Covington report.

- Empowering senior leadership through the Head of Diversity who is responsible for diversity and inclusion.
- Creating a Board oversight committee, such as an Ethics and Culture Committee, to oversee Uber's efforts and enhance a culture of ethical business practices, diversity, and inclusion within the organization.
- Enhancing the role and responsibilities of the audit committee and internal controls with respect to diversity and inclusion compliance.
- Training key personnel in inclusive leadership and to combat implicit bias.
- Providing an effective complaint process for employees to address harassment, discrimination, and retaliation in the workplace.
- Establishing an employee diversity advisory board to funnel input and ideas to the Head of Diversity.
- Targeting diverse sources of talent, including alternative and non-traditional sources of recruiting, and developing deeper partnerships with Historically Black Colleges and Universities and Hispanic-Serving Institutions.
- Adopting a version of the "Rooney Rule" originally established by the National Football League (NFL) that requires each NFL franchise to interview at least one woman and one member of an underrepresented minority group for key managerial positions.
- Supporting employee efforts to enhance a diverse workplace environment through the performance review process.
- Eliminating bias and misuse of the performance review process.
- Reviewing compensation practices to ensure compensation policies and practices comply with state and federal equal pay laws.

Ferrell et al. point out that people can act unethically by failing to identify the ethical dimensions of a situation. Ethical blindness results from individuals who fail to sense the nature and complexity of their decisions.[46] Decision-making at Uber with respect to how female employees were treated illustrates what can happen when a company has a blind spot with respect to equity, diversity, and inclusion. The Covington report identifies the areas of risk for Uber and concludes that if the company commits to following the recommendations, Uber should be better positioned to create a corporate culture that values EDI and commits to incorporating it into their strategic policies.

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EXHIBIT 2.2 Sexual Harassment Charges at Uber

Sexual harassment charges at Uber came to light on February 19, 2017, when former Uber engineer, Susan Fowler, published a blog post about behavior towards women at Uber.[47] Fowler detailed how, after joining Uber, she became part of a team. Her manager quickly sent her a string of messages about the open relationship he had with his girlfriend, and how he wasn't having as much luck as she was in finding sexual partners. Fowler took this as a blatant attempt by her superior to get her to sleep with him. She took a screen shot of his come-on and reported him. Human Resources told her even though this was harassment, nothing would be done. The manager was highly regarded and it was his first offense. Fowler was told her choice was to forget about it, be reassigned, or stay put even though the manager, who knew he had been reported, might give her a poor performance review.

Reassigned, Fowler wrote she later found out that the manager was openly propositioning female team members. She also discovered and wrote about a sexist corporate culture where women saw their performance evaluations retroactively downgraded when it suited male managers.

Ultimately, in response to Fowler's claim of sexual harassment and similar accusations, Uber fired 20 employees, including senior executives, and reprimanded 40 more employees. Uber commissioned an investigation of its workplace practices by Covington & Burling LLP ("Covington"), which was headed by Eric Holder, former Attorney General of the U.S. Specifically, Covington was asked to conduct a thorough and objective review regarding "the specific issues relating to work place environment raise by Fowler, as well as diversity and inclusion at Uber more broadly."

The Covington report was issued on June 13, 2017. Uber founder and CEO Travis Kalanick accepted responsibility for the company's state and told employees that he'd be taking an indefinite leave of absence. Following that, the company announced that Emil Michael, vice president for business, was also leaving. Then Uber board member and hedge fund partner David Bonderman resigned after making what he called an inappropriate remark about women at a company meeting.[48]

The sexual harassment case took a strange turn on November 30, 2017, when one of Uber's early investors and Hyperloop co-founder, Shervin Pishevar, was accused by at least five women of sexual harassment or assault. Pishevar allegedly made unwanted sexual advances or harassed them. The women accused Pishevar of exploiting a professional connection or offering the prospect of a job or investment to commit sexual assaults.[49]

The Covington report lays out a strong case for a company that lacked guidelines on issues of diversity and inclusion and an indifference to what was going on in the company. Holder suggested that Uber change its written cultural values to promote positive behavior, inclusion, and collaboration. That means doing away with values that justified poor behavior, such as "Let Builders Build," "Always Be Hustlin'," Meritocracy and Toe-Stepping" and "Principled Confrontation."

The recommendations in the report are designed to improve Uber's culture, promote fairness and accountability, and establish processes and systems to ensure the mistakes of the past would not repeated. The goal is to rebuild trust with Uber employees, riders, and drivers. Specifically, the new plan calls for Uber to forbid "any type of romantic or intimate relationship between individuals in a reporting relationship."[50]

Kohlberg and the Cognitive Development Approach

LO 2-4

Describe Kohlberg's stages of moral development.

Cognitive development refers to the thought process followed in one's moral development. An individual's ability to make reasoned judgments about moral matters develops in stages. The psychologist Lawrence Kohlberg concluded, on the basis of 20 years of research, that people develop from childhood to adulthood through a

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sequential and hierarchical series of cognitive stages that characterize the way they think about ethical dilemmas. Moral reasoning processes become more complex and sophisticated with development. Higher stages rely upon cognitive operations that are not available to individuals at lower stages, and higher stages are thought to be "morally better" because they are consistent with philosophical theories of justice and rights.[51] Kohlberg's views on ethical development are helpful in understanding how individuals may internalize moral standards and, as they become more sophisticated in their use, apply them more critically to resolve ethical conflicts.

Kohlberg developed his theory by using data from studies on how decisions are made by individuals. The example of Heinz and the Drug, given here, illustrates a moral dilemma used by Kohlberg to develop his stage-sequence model.

Heinz and the Drug

In Europe, a woman was near death from a rare type of cancer. There was one drug that the doctors thought might save her. It was a form of radium that a druggist in the same town had recently discovered. The drug was expensive to make, but the druggist was charging 10 times what the drug cost him to make: It cost $200 for the radium, and he charged $2,000 for a small dose of the drug. The sick woman's husband, Heinz, went to everyone he knew to borrow the money, but he could get together only about $1,000—half the cost. He told the druggist that his wife was dying and asked him to sell it cheaper or let him pay later. But the druggist said, "No, I discovered the drug and I'm going to make money from it." Heinz got desperate and broke into the man's store to steal the drug for his wife.

Should the husband have done that? Was it right or wrong? Most people say that Heinz's theft was morally justified, but Kohlberg was less concerned about whether they approved or disapproved than with the reasons they gave for their answers. Kohlberg monitored the reasons for judgments given by a group of 75 boys ranging in age from 10 to 16 years and isolated the six stages of moral thought. The boys progressed in reasoning sequentially, with most never reaching the highest stages. He concluded that the universal principle of justice is the highest claim of morality.

The dilemma of Heinz illustrates the challenge of evaluating the ethics of a decision. Table 2.1 displays three types of responses.[52]

TABLE 2.1 Three Sample Responses to the Heinz Dilemma

A:	It really depends on how much Heinz likes his wife and how much risk there is in taking the drug. If he can get the drug in no other way and if he really likes his wife, he'll have to steal it.
B:	I think that a husband would care so much for his wife that he couldn't just sit around and let her die. He wouldn't be stealing for his own profit; he'd be doing it to help someone he loves.
C:	Regardless of his personal feelings, Heinz has to realize that the druggist is protected by the law. Since no one is above the law, Heinz shouldn't steal it. If we allowed Heinz to steal, then all society would be in danger of anarchy.

Kohlberg considered how the responses were different and what problem-solving strategies underlie the three responses. Response A (Preconventional) presents a rather uncomplicated approach to moral problems. Choices are made based on the wants of the individual decision maker (egoism). Response B (Conventional) also considers the wife's needs. Here, Heinz is concerned that his actions should be motivated by good intentions (i.e., the end justifies the means). In Response C (Postconventional), a societywide perspective is used in decision making. Law is the key in making moral decisions[53] (for example, rule utilitarianism; justice orientation).

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The examples in Table 2.2 demonstrate the application of Kohlberg's model of cognitive development to possible decision making in business.

Relating Kohlberg's stages to cognitive biases, individual's reasoning at stage 3 could be affected by "groupthink." Groupthink manifests itself in group decision making that discourages individuality and

TABLE 2.2 Kohlberg's Stages of Moral Development

Level 1—Preconventional
At the preconventional level, the individual is very self-centered. Rules are seen as something external imposed on the self.
Stage 1: Obedience to Rules; Avoidance of Punishment At this stage, what is right is judged by one's obedience to rules and authority. *Example:* A company forbids making payoffs to government or other officials to gain business. Susan, the company's contract negotiator, might justify refusing the request of a foreign government official to make a payment to gain a contract as being contrary to company rules, or Susan might make the payment if she believes there is little chance of being caught and punished.
Stage 2: Satisfying One's Own Needs In Stage 2, rules and authority are important only if acting in accordance with them satisfies one's own needs (egoism). *Example:* Here, Susan might make the payment even though it is against company rules if she perceives that such payments are a necessary part of doing business. She views the payment as essential to gain the contract. Susan may believe that competitors are willing to make payments, and that making such payments are part of the culture of the host country. She concludes that if she does not make the payment, it might jeopardize her ability to move up the ladder within the organization and possibly forgo personal rewards of salary increases, bonuses, or both. Because everything is *relative,* each person is free to pursue her individual interests.
Level 2—Conventional
At the conventional level, the individual becomes aware of the interests of others and one's duty to society. Personal responsibility becomes an important consideration in decision making.
Stage 3: Fairness to Others In Stage 3, an individual is not only motivated by rules but seeks to do what is in the perceived best interests of others, especially those in a family, peer group, or work organization. There is a commitment to loyalty in the relationship. *Example:* Susan wants to be liked by others. She might be reluctant to make the payment but agrees to do so, not because it benefits her interests, but in response to the pressure imposed by her supervisor, who claims that the company will lose a major contract and employees will be fired if she refuses to go along.

(*Continued*)

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Stage 4: Law and Order

Stage 4 behavior emphasizes the morality of law and duty to the social order. One's duty to society, respect for authority, and maintaining the social order become the focus of decision making.

Example: Susan might refuse to make the illegal payment, even though it leads to a loss of jobs in her company (or maybe even the closing of the company itself), because she views it as her duty to do so in the best interests of society. She does not want to violate the law.

Level 3—Postconventional

Principled morality underlies decision making at this level. The individual recognizes that there must be a societywide basis for cooperation. There is an orientation to principles that shape whatever laws and role systems a society may have.

Stage 5: Social Contract

In Stage 5, an individual is motivated by upholding the basic rights, values, and legal contracts of society. That person recognizes in some cases that legal and moral points of view may conflict. To reduce such conflict, individuals at this stage base their decisions on a rational calculation of benefits and harms to society.

Example: Susan might weigh the alternative courses of action by evaluating how each of the groups is affected by her decision to make the payment. For instance, the company might benefit by gaining the contract. Susan might even be rewarded for her action. The employees are more secure in their jobs. The customer in the other country gets what it wants. On the other hand, the company will be in violation of the Foreign Corrupt Practices Act (FCPA), which prohibits (bribery) payments to foreign government officials. Susan then weighs the consequences of making an illegal payment, including any resulting penalties, against the ability to gain additional business. Susan might conclude that the harms of prosecution, fines, other sanctions, and the loss of one's reputational capital are greater than the benefits.

Stage 6: Universal Ethical Principles

Kohlberg was still working on Stage 6 at the time of his death in 1987. He believed that this stage rarely occurred. Still, a person at this stage believes that right and wrong are determined by universal ethical principles that everyone should follow. Stage 6 individuals believe that there are inalienable rights, which are universal in nature and consequence. These rights, laws, and social agreements are valid not because of a particular society's laws or customs, but because they rest on the premise of universality. Justice and equality are examples of principles that are deemed universal. If a law conflicts with an ethical principle, then an individual should act in accordance with the principle.

An example of such a principle is Immanuel Kant's categorical imperative, the first formulation of which can be stated as: "Act only according to that maxim [reason for acting] by which you can at the same time will that it would become a universal law."[54] Kant's categorical imperative creates an absolute, unconditional requirement that exerts its authority in all circumstances, and is both required and justified as an end in itself.

Example: Susan would go beyond the norms, laws, and authority of groups or individuals. She would disregard pressure from her supervisor or the perceived best interests of the company when deciding what to do. Her action would be guided only by universal ethical principles that would apply to others in a similar situation.

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personal responsibility. In this stage, peer pressure influences decision making. A good example is the case of Cynthia Cooper at WorldCom. Cooper was pressured not only by the CFO, Scott Sullivan, but also the audit committee that initially backed away from any support for her position. Still, she persisted and eventually uncovered and reported the fraud at the company. Cooper's reasoning was at the postconventional level.

Let's return to the receivables example in Chapter 1 that applies ethical reasoning to the methods discussed in Exhibit 1.3 (Ethical Reasoning Method Bases for Making Ethical Judgments). In the receivables example, an auditor who reasons at Stage 3 might go along with the demands of a client out of loyalty or because she thinks the company will benefit by such inaction. At Stage 4, the auditor places the needs of society and abiding by the law (GAAP, in this instance) above all else, so the auditor will insist on recording an allowance for uncollectibles.

An auditor who reasons at Stage 5 would not want to violate the public interest principle embedded in the profession's ethical standards, which values the public trust above all else. Investors and creditors have a right to know about the uncertainty surrounding collectibility of the receivables. At Stage 6, the auditor would ask whether she would want other auditors to insist on providing an allowance for the uncollectibles if they were involved in a similar situation. This creates an objective standard for determining the right decision. The auditor reasons that the orderly functioning of markets and a level playing field require that financial information should be accurate and reliable, so another auditor should also decide that the allowance needs to be recorded. The application of the ethical principles of objectivity and integrity in the AICPA Code enables her to carry out the ethical action and act in a responsible manner.

Kohlberg's model suggests that people continue to change their decision priorities over time and with additional education and experience. They may experience a change in values and ethical behavior.[55] In the context of business, an individual's moral development can be influenced by corporate culture, especially ethics training.[56] Ethics training and education have been shown to improve managers' moral development. More will be said about corporate culture in Chapter 3.

Kohlberg maintains that his stage sequence is universal; it is the same in all cultures. William Crain addresses whether different cultures socialize their children differently, thereby teaching them different moral beliefs.[57] He points out that Kohlberg's response has been that different cultures do teach different beliefs, but that his stages refer not to specific beliefs, but to underlying modes of reasoning. We might assume, then, in a collectivist society, which exists in many Asian cultures, blowing the whistle on a member of a work group would be considered improper because of the "family" orientation or team player mentality (Stage 3), while in a more individualistic one, such as exists in the U.S., it is considered acceptable because it is in the best interests of society (Stage 4). Thus, individuals in different cultures at the same stage-sequence might hold different beliefs about the appropriateness of whistleblowing but still reason the same because, from a fairness perspective, it is the right way to behave.

The Ethical Domain in Accounting and Auditing

LO 2-5

Explain how cognitive processes influence ethical decision making in accounting.

A commitment to serve the public interest is the bedrock of the accounting profession. Snoeyenbos, Almeder, and Humber have described this as a "social contract" in which the professional discharges his obligation by operating with high standards of expertise and integrity. When the profession does not maintain these standards, the social contract is broken, and society may decide to limit the role or the

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autonomy of the profession. This occurred in the aftermath of the accounting scandals when Congress passed the Sarbanes-Oxley Act (SOX) and established the Public Company Accounting Oversight Board (PCAOB) to oversee the auditing, ethics, and independence practices of CPA firms that audit companies with stock listed on the New York Stock Exchange (NYSE) and NASDAQ. For nonpublicly-owned companies, the standards of the AICPA still apply.[58]

The ethical domain for accountants and auditors usually involves four key constituent groups, including (1) the client organization that hires and pays for accounting services; (2) the accounting firm that employs the practitioner, typically represented by the collective interests of the firm's management; (3) the accounting profession, including various regulatory bodies such as the Securities and Exchange Commission (SEC) and the PCAOB; and (4) the general public, who rely on the attestations and representations of the practitioner and the firm.[59] Responsibilities to each of these groups may conflict. For example, fees are paid by the client organization rather than by the general public, including investors and creditors who are the direct beneficiary of the independent auditing services, so the public interest may conflict with client interests. These conflicts might influence the cognitive development of auditors, thereby influencing their ethical reasoning.

The accounting profession's codes of conduct that were discussed in Chapter 1 encourage the individual practitioner's ethical behavior in a way that is consistent with the stated rules and guidelines of the profession. These positive factors work in conjunction with an individual's attitudes and beliefs and ethical reasoning capacity to influence professional judgment and ethical decision making. Biases can creep into decision making, leading the auditor to be overconfident about his ability to properly assess risk on the audit.

One type of bias that fits into the discussion of moral development is conformity bias. In every aspect of their lives, people take cues from those around them about the proper way to act. By observing others in the workplace new hires learn the culture of the organization and expected behavior. The conformity bias strongly pushes people to conform their judgments to those of their reference group. A good example is at Enron where freshly minted MBAs were acculturated into Enron's fast-and-loose corporate style without fully recognizing the ethical implications of company practices. At Enron, the "everybody else is doing it" explanation was used to justify the earnings manipulations.[60]

Kohlberg's theory of ethical development provides a framework that can be used to consider the effects of conflict areas on ethical reasoning in accounting. For example, if an individual accountant is influenced by the firm's desire to "make the client happy," then the result may be reasoning at Stage 3. The results of published studies during the 1990s by accounting researchers indicate that CPAs reason primarily at Stages 3 and 4. One possible implication of these results is that a larger percentage of CPAs may be overly influenced by their relationship with peers, superiors, and clients (Stage 3) or by rules (Stage 4). A CPA who is unable to apply the technical accounting standards and rules of conduct critically when these requirements are unclear is likely to be influenced by others in the decision-making process.[61] If an auditor reasons at the postconventional level, then that person may refuse to give in to the pressure applied by the supervisor to overlook the client's failure to follow GAAP. This is the ethical position to take, although it may go against the culture of the firm to "go along to get along."

Empirical studies have explored the underlying ethical reasoning processes of accountants and auditors in practice. Findings show that ethical reasoning may be an important determinant of professional judgment, such as the disclosure of sensitive information[62] and auditor independence.[63] Results also show that unethical and dysfunctional audit behavior, such as the underreporting of time on an audit budget, may be systematically related to the auditor's level of ethical reasoning.[64] In reviewing these and other works, Ponemon and Gabhart conclude that the results imply that ethical reasoning may be an important cognitive characteristic that affects individual judgment and behavior under a wide array of conditions and events in extant professional practice.[65]

The role of an accountant is to tell a story—to make an account—of a series of business activities. This story can be told from a variety of perspectives (i.e., employer or client) and can therefore result in many accounts. It is the role of the accountant to determine the perspective that will fairly present the

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information in accordance with laws and accounting standards, but they contain options and ambiguities. A higher level of understanding is required to deal with these different perspectives, the options and ambiguities that exist within the standards, and the uncertainties of business life. This higher level of understanding is encapsulated in the postconventional level of reasoning.[66]

Moral Reasoning and Moral Behavior

Within the cognitive-developmental paradigm the most distinguishing characteristic of morality is the human capacity to reason. Moral judgment has long been regarded as the single most influential factor—and the only truly moral determinant—of a person's moral behavior.[67] By definition, morality requires that a person's actions be rational, motivated by purpose or intent, and carried out with autonomous free will. Kohlberg maintained that it is as a result of development in moral reasoning that one becomes truly a moral person in both mind and deed.[68]

Kohlberg's work is not without its critics. Some philosophers complain it draws too heavily from Rawls's Theory of Justice and makes deontological ethics superior to other ethical perspectives. They note that the theory applies more to societal issues than to individual ethical decisions. A number of psychologists have challenged the notion that people go through "rigid" stages of moral reasoning, arguing instead that they can engage in many ways of thinking about a problem, regardless of their age.[69]

Although he later admitted to having underestimated the complexity of the relation between moral stage and action and revised his thinking to include two intervening cognitive functions to explain it—a prescriptive judgment of the moral right and a personal judgment of responsibility to act accordingly—Kohlberg still contended that it is the logic of a person's reasoning that most strongly influences his moral behavior. Thus, reason constitutes the essential core and strength of character of a person's moral maturity in Kohlberg's theory.[70]

Kohlberg's commitment to reason has been challenged by some who claim he disregarded other factors also associated with moral functioning, such as emotion[71] and traits of character.[72] Others have criticized Kohlberg's emphasis on reason without considering its interaction with other components of morality and its link to moral behavior in particular.[73] Still others claim the over-reliance on dilemmas, such as Heinz and the Drug, to evaluate moral reasoning shortchanges the role of virtue ethics and its focus on the character of individuals and their overall approach to life.[74]

Noted moral psychologist James Rest attempted to address some of the problems that are recognized in Kohlberg's work, and in doing so has moved from the six-stage model to one with three levels of understanding: personal interest, maintaining norms, and postconventional. Rest focuses on the maintaining norms (similar to the conventional level) and postconventional schemas. By maintaining norms, Rest means recognizing the need for societywide norms; a duty orientation; the need for cooperation; uniform and categorical application of norms, laws, and rules; and that individuals will obey the norms and laws and expect others to do the same even though it may not benefit all affected parties equally.[75]

Rest's conception has particular appeal for accountants who, at this level of moral development, recognize the importance of various laws and standards, comply with them, understand that sometimes compliance would benefit them and sometimes not, but recognize that obeying these norms is important for society. Rest recognized that, while operating at this level would be ideal for an accountant, it does not ensure that the accountant can make good decisions when there are options and ambiguities within accounting and auditing standards, nor does it ensure that he will have the ability to make good decisions when business circumstances arise that are outside the current laws, norms, or standards.[76]

A higher level of understanding is needed to deal with these different perspectives. The postconventional schema integrates such issues by recognizing that accountants do not have to follow the norms but should seek the moral criteria behind the norms for guidance in action. In accounting this means the fair presentation of financial information in a way that benefits society—that is, the public interest.

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Rest's Four-Component Model of Ethical Decision Making

LO 2-6

Explain Rest's model and how its components influence ethical decision making.

Cognitive-developmental researchers have attempted to understand the process of ethical decision making. In particular, Rest asserts that ethical actions are not the outcome of a single, unitary decision process, but result from a combination of various cognitive structures and psychological processes. Rest's model of ethical action is based on the presumption that an individual's behavior is related to his level of moral development. Rest built on Kohlberg's work by developing a four-component model of the ethical decision-making process. The four-component model describes the cognitive processes that individuals use in ethical decision making; that is, it depicts how an individual first identifies an ethical dilemma and then continues through to his moral motivation and finally finds courage to behave ethically. Each component of the model must be present before the moral action will be undertaken.[77]

Rest built his four-component model by working backward. He started with the end product—to take ethical action—and then determined the steps that produce such behavior. He concluded that ethical action is the result of four psychological processes: (1) moral sensitivity (recognition), (2) moral judgment (reasoning), (3) moral focus (motivation), and (4) moral character (action).

Moral Sensitivity

The first step in moral behavior requires that the individual interpret the situation as moral. Absent the ability to recognize that one's actions affect the welfare of others, it would be virtually impossible to make the most ethical decision when faced with a moral dilemma.

Aaron Beam was unable to spot the ethical issues. He felt uncomfortable with what Richard Scrushy had asked him to do and that it was wrong to manipulate the numbers, yet he went along anyway; perhaps because he figured it was a one-time maneuver. He failed to see how his silence would affect others but found out the hard way on March 26, 2003 when HealthSouth's shares lost 97% of their value as news of the accounting fraud surfaced.

Moral Judgment

An individual's ethical cognition of what "ideally" ought to be done to resolve an ethical dilemma is called *prescriptive reasoning.*[78] The outcome of one's prescriptive reasoning is his ethical judgment of the ideal solution to an ethical dilemma. Generally, an individual's prescriptive reasoning reflects his cognitive understanding of an ethical situation as measured by his level of moral development.[79] Once a person is aware of possible lines of action and how people would be affected by the alternatives, a process aided by the philosophical reasoning methods, a judgment must be made about which course of action is more morally justifiable (which alternative is just or right).

Moral judgment relates to developing moral reasoning abilities over time. Kohlberg believed that people engage in more complex reasoning as they progress up the stages and become less self-centered and develop broader definitions of morality. Rest added that developing moral judgment is a social and cognitive construct that progressed from a self-focused view of moral issues through a group-based moral perspective to a reliance on postconventional moral principles and a primary factor in the understanding of moral actions and emotions.

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Moral Focus

After concluding what course of action is best, decision makers must be focused on taking the moral action and follow through with ethical decision making. Moral values may conflict with other values. Moral motivation reflects an individual's willingness to place ethical values (e.g., honesty, integrity, trustworthiness, caring, and empathy) ahead of nonethical values (e.g., wealth, power, and fame) that relate to self-interest. An individual's ethical motivation influences his intention to comply or not comply with his ethical judgment in the resolution of an ethical dilemma.

Sometimes individuals want to do the right thing but are overwhelmed by countervailing pressures that may overpower their ethical intentions because of perceived personal costs. The loss of a job or a client can be motivating factors that compromise integrity and block ethical action. With Betty Vinson, fear for her job and ability to support her family tainted her motivation to do the right thing and refuse to record improper accounting.

Emotions also play a part in moral motivation. Organizations should create ethically rewarding environments to increase moral motivation. To reduce the costs of behaving morally, policies and procedures should be instituted that make it easier to report unethical behavior, prevent retaliation, and create an ethical culture in the organization. Leaders have to inspire employees and build confidence that their ethical intentions are supported by organizational systems.

Moral Character

As we learned in the discussion of cognitive dissonance, individuals do not always behave in accordance with their ethical intention. An individual's intention to act ethically and his ethical actions may not be aligned because of pressures or biases that influence decision making. Individuals with strong ethical character will be more likely to carry out their ethical intentions with ethical action than individuals with a weak ethical character because they are better able to withstand any pressures (i.e., have courage and maintain integrity to do otherwise).

Executing a plan of action takes character. Moral agents have to overcome indifference and opposition, resist distractions, cope with fatigue, and develop tactics and strategies for reaching their goals. Johnson points out that this helps to explain why there is only a moderate correlation between moral judgment and moral behavior. Many times deciding does not lead to doing.[80]

The four components of Rest's model are processes that must take place for moral behavior to occur. Rest does not offer the framework as a linear decision-making model, suggesting instead that the components interact through a complicated sequence of "feed-back" and "feed-forward" loops. An individual who demonstrates adequacy in one component may not necessarily be adequate in another, and moral failure can occur when there is a deficiency in any one component.[81] For example, an individual who has good moral reasoning capacity, a skill that can be developed (Component 2), may fail to perceive an ethical problem because he does not clearly understand how others might feel or react—a lack of empathy (Component 1).

Moral Intensity

LO 2-7

Describe the link between moral intensity and ethical decision making.

The lack of research on the characteristics of a moral issue prompted Thomas Jones to develop the moral intensity model. He argued that the characteristics of the moral issue—what he collectively termed

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moral intensity—influence ethical decision making. Jones's model links moral intensity to Rest's Four-Component Model. For example, social consensus and magnitude of consequences are strong predictors of moral judgment. Social consensus, magnitude of consequences, and probability of effect are strong predictors of moral intention. The six dimensions of Jones's model are briefly explained below.[82]

Magnitude of Consequences refers to the degree to which an individual may be harmed or benefited by the decision maker's action. A greater degree of harm or benefit results in an increase in moral intensity.

Temporal Immediacy refers to the length of time between the action and its consequences. An action with immediate negative consequences will cause a greater increase in moral intensity than an action for which the consequences are delayed.

Social Consensus refers to the degree of agreement among a social group that an action is good or bad. This social group could be society as a whole (e.g., a fraudulent financial statement is not morally accepted by society because accounting rules and SEC laws prohibit it). A strong Social Consensus that an act is morally wrong increases moral intensity.

Proximity refers to the nearness of the decision maker to the individuals potentially affected by the consequences. An increase in proximity results in an increase of moral intensity. An auditor who becomes too close to a client and is dealing with fraudulent financial statements is likely to feel more pressure from the client because of their close relationship.

Probability of Effect refers to the likelihood that the predicted consequences and the expected level of harm/benefit will occur. Moral intensity increases with an action that has a high probability of occurrence and high likelihood of causing predicted harm. Pressures increase on auditors when harm to the public interest intensifies with the likelihood of fraudulent financial statements.

Concentration of Effect refers to the relationship between the number of people affected and the magnitude of harm. Moral intensity increases if the Concentration of Effect is great. Fraudulent financial statements issued by a publicly owned company that is also using the statements for a significant loan creates additional pressures on auditors to make the most ethical decision possible.[83]

Morally intense situations raise the stakes with respect to ethical decision making. In accounting, possible harms to investors and creditors, the likelihood of occurring, and deviation from GAAP increase the intensity of decisions and can create obstacles to ethical decision making.

Aligning Ethical Behavior and Ethical Intent

LO 2-8

Explain how moral reasoning and virtue influence ethical decision making.

One question that arises from Rest's model is how to align ethical behavior with ethical intent. The answer is through the exercise of virtue, according to a study conducted by Libby and Thorne.[84] The authors point out that audit failures at companies such as Enron and WorldCom demonstrate that the rules in accounting cannot replace auditors' professional judgment. Transactions such as the special-purpose entities at Enron can be structured around rules, and rules cannot be made to fit every situation. The rules may be unclear or nonexistent, in which case professional judgment is necessary for decisions to be made in accordance with the values of the profession as embodied in its codes of conduct. Professional judgment requires not only technical competence, but also depends on auditors' ethics and virtues that inform ethical decision making.

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Libby and Thorne surveyed members of the Canadian accounting community with the help of the Canadian Institute of Chartered Accountants (CICA), the equivalent of the AICPA in the United States, to develop a set of virtues important in the practice of auditing.[85] The authors divided the virtues into two categories: intellectual virtues which indirectly influence an individual's intentions to exercise professional judgment and instrumental virtues which directly influence an individual's actions. The most important intellectual virtues were found to be integrity, truthfulness, independence, objectivity, dependability, being principled, and healthy skepticism. The most important instrumental virtues were diligence (i.e., due care) and being alert, careful, resourceful, consultative, persistent, and courageous. The authors concluded from their study that virtue plays an integral role in the intention to exercise professional judgment, the exercise of professional judgment, and the necessity of possessing both intellectual and instrumental virtues for auditors.

Intellectual virtues aim at cognitive goods through the pursuit of truth, knowledge, and understanding. They can be thought of as qualities of mind and character that enable an auditor to act with good purpose. Intellectual virtues are developed over time by gaining knowledge and skills through experiences that develop one's ability to reason through difficult situations, develop good judgment, and ultimately gain practical wisdom.

Returning now to Rest's model, Thorne contends that the model fails to provide a theoretical description of the role of personal characteristics, except for level of moral development, in auditors' ethical decision processes. Thorne develops a model of individuals' ethical decision processes that integrates Rest's components with virtue-based characteristics, which, taken together, tend to increase the decision maker's propensity to exercise sound ethical judgment. Thorne believes that virtue theory is similar to the approach advocated by the cognitive-developmental perspective in three ways. First, both perspectives suggest that ethical action is the result of a rational decision-making process. Second, both perspectives are concerned with an individual's ethical decision-making process. Third, both perspectives acknowledge the critical role of cognition in individuals' ethical decision making. Exhibit 2.3 presents Thorne's integrated model of the ethical decision-making process.[86]

EXHIBIT 2.3 Thorne's Integrated Model of Ethical Decision Making[87]

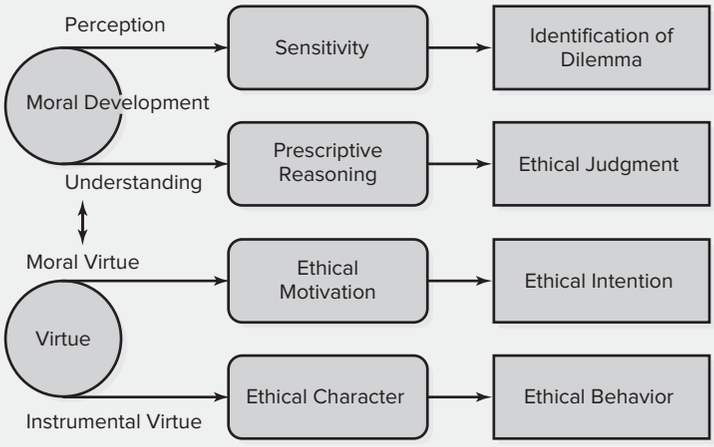

Exhibit 2.3 indicates that moral development and virtue are both required for ethical behavior. In her examination of the model, Armstrong suggests that moral development comprises sensitivity to the moral content of a situation or dilemma and prescriptive reasoning, or the ability to understand the issues, think them through, and arrive at an ethical judgment. Similarly, virtue comprises ethical motivation which

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describes an individual's willingness to place the interests of others ahead of his own interest and ethical character which leads to ethical behavior.[88]

Even though virtue is a critical component of ethical behavior, other factors may get in the way of taking ethical action, including situational pressures, business norms, and the moral intensity of the issue itself that influences ethical decision making. Also, one's strength of character deepens with experience, and reflection on ethical dilemmas can bolster one's resolve.

Ethical Decision-Making Models

LO 2-9

Apply the steps in the Integrated Ethical Decision-Making Model to a case study.

Dealing with moral issues can be perplexing. How, exactly, should we think through an ethical issue? What questions should we ask? What factors should we consider? The philosophical methods of moral reasoning suggest that once we have ascertained the facts, we should ask ourselves five questions when trying to resolve a moral issue:

- What benefits and what harms will each course of action produce, and which alternative will lead to the best overall consequences?
- What moral rights do the affected parties have, and which course of action best respects those rights?
- Which course of action treats everyone the same, except where there is a morally justifiable reason not to, and does not show favoritism, discrimination, or other biased behaviors?
- Which course of action advances the common good?
- Which course of action develops moral virtues?

In commenting on these questions, Velasquez points out that they do not provide an automatic solution to moral problems. It is not meant to. The reasoning is merely meant to help identify most of the important ethical considerations. In the end, we must deliberate on moral issues for ourselves, keeping a careful eye on both the facts and on the ethical considerations involved.[89]

Decision-making guidelines can help us make better ethical choices. Johnson points out that taking a systematic approach encourages teams and individuals to carefully define the problem, gather information, apply ethical standards and values, identify and evaluate alternative courses of action, and follow through on their choices. They are also better equipped to defend their decisions.

Kidder's Ethical Checkpoints

Ethicist Rushworth Kidder acknowledges that ethical issues can be "disorderly and sometimes downright confusing." They can arise suddenly, create complex issues, and have unexpected consequences. However, Kidder argues that there is an underlying structure to the ethical decision-making process.[90] Kidder suggests that nine steps or checkpoints can help bring order to otherwise confusing ethical issues. What follows is a brief summary of the major points.

1. *Recognize that there is a moral issue.* Similar to Rest's notion of ethical sensitivity, we must acknowledge that an issue deserves our attention and moral questions exist.

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2. *Determine the actor.* Kidder distinguishes between involvement and responsibility. Because we are members of larger communities, we are involved in any ethical issue that arises in the group. Yet we are only responsible for dealing with problems that we can do something about. For example, I may be concerned that clients threaten to fire their auditors if they plan to give a negative opinion on the financial statements. However, there is little I can do about it unless it happens in my firm.
3. *Gather the relevant facts.* Adequate, accurate, and current information is important for making effective decisions of all kinds, including ethical ones. Consider the motives of affected parties, patterns of behavior, likely consequences if the problem persists, and likely outcome of one course of action or another.
4. *Test for right-versus-wrong issues.* Kidder suggests using four determinations including a *legal test.* If lawbreaking is involved (i.e., fraudulent financial statements), then the problem becomes a legal matter, not a moral one. The *smell test* relies on intuition. If you have an uneasy feeling about the decision or course of action, chances are it involves right-versus-wrong issues. The *front-page test* asks how you would feel if your decision made it to the front page of the local newspaper. If you feel uncomfortable about it, then you should consider choosing another alternative. The *mom test* asks how you would feel if your mother or some other important role model became aware of your choice. If you have a queasy feeling, then it is best to reconsider your choice.
5. *Test for right-versus-right paradigms.* If an issue does not involve wrong behavior, then it likely pits two important positive values against each other. Kidder identified four such models: truth-telling versus loyalty to others and institutions; personal needs versus needs of the community; short-term benefits versus long-term negative consequences; and justice versus mercy. When an ethical dilemma pits two core values against each other, a determination should be made whether they are in conflict with one another in this situation. For example, it is important to be loyal to one's supervisor, but not at the risk of presenting biased financial information.
6. *Apply the ethical standards and perspectives.* Consider which ethical principle is most relevant and useful to this specific issue. Is it utilitarianism? Kant's categorical imperative? Justice as fairness? What is the role of virtue? Or, is it a combination of perspectives?
7. *Look for a third way.* Compromise is one way to reveal a new alternative that will resolve the problem or to develop a creative solution. A third way can also be the product of moral imagination. One's conception of the moral and ethical issues can change when considering different perspectives from a moral point of view. We may discover a better, economically viable, and morally justifiable solution.
8. *Make the decision.* At some point we have to make the decision. However, we may be mentally exhausted from wrestling with the problem, get caught up in analysis paralysis, or lack the necessary courage to come to a decision.
9. *Revisit and reflect on the decision.* Return to the decision later, after the issue has been resolved, to debrief. Reflect on the lessons to be learned. How can you apply them to future decisions? What ethical issues did it raise?

Johnson points out that it is not easy to determine who has responsibility for solving a problem, the facts may not be available, or a time constraint prevents gathering all the relevant information, and decisions do not always lead to action. The model seems to equate deciding with doing and, as we saw in our earlier discussion of moral action, we can decide on a course of action but not follow through. Johnson concludes that Kidder is right to say that making ethical choices takes courage. However, it takes even more courage to put the choice into effect.[91]

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We believe that a decision-making process in accounting helps to organize one's thoughts about the ethical issues that accounting professionals face and can serve as a basis for analysis in many of the cases in this book. The integrated model explained below draws on Rest's Model and Kidder's Checkpoints to provide a basis for ethical decision making when accounting issues create ethical dilemmas. Consideration is given to moral intensity and how intellectual and instrumental virtues enable ethical action to occur.

The integrated model links to Rest's framework as follows:

Integrated Ethical Decision-Making Process

1. **Identify the ethical and professional issues (ethical sensitivity).**
   - *What are the ethical and professional issues in this case (i.e., GAAP and GAAS)?*
   - *Who are the stakeholders (i.e., investors, creditors, employees, management, the organization)?*
   - *Which ethical/professional standards apply (i.e., AICPA Code Principles, IMA Ethical Standards, and IIA code of ethics)?*
2. **Identify and evaluate alternative courses of action (ethical judgment).**
   - *What legal issues exist?*
   - *What can and cannot be done in resolving the conflict under professional standards?*
   - *Which ethical reasoning methods apply to help reason through alternatives (i.e., rights theory, utilitarianism, justice, and virtue)?*
3. **Reflect on the moral intensity of the situation and virtues that enable ethical action to occur (ethical intent).**
   - *Evaluate the magnitude of the consequences if specific actions are taken; likelihood of those consequences; ability to effect ethical responses by one's actions; consensus view within the profession about the appropriateness of the intended actions.*
   - *Consider whether anyone's rights are at stake and how they manifest in the decision-making process.*
   - *Consider how virtue (i.e., intellectual virtues) motivates ethical actions.*
   - *Evaluate social and organizational pressures and its effect on decision making.*
4. **Take action (ethical behavior).**
   - *Decide on a course of action consistent with one's professional obligations.*
   - *How can virtue (i.e., instrumental virtue) support turning ethical intent into ethical action?*
   - *What steps can I take to strengthen my position and argument?*
   - *How can I counter reasons and rationalizations that mitigate against taking ethical action? Who can I go to for support?*

Reflection would follow after the decision has been made. What was the outcome? How should it affect my approach to ethical decision making? How can I do better in the future?

Application of the Integrated Ethical Decision-Making Model: Ace Manufacturing

In order to illustrate the use of the model, a short case appears in Exhibit 2.4. The facts of the case and ethical issues are analyzed below using the Integrated Model. It is not our intention to cover all points; instead, it is to illustrate the application of the model and consideration of Rest's framework, moral intensity, and the virtues previously discussed and identified in Thorne's study.

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EXHIBIT 2.4 Ace Manufacturing

Ace Manufacturing is a privately held company in Anytown, USA. There are three stockholders of the company—Joe Smith, Sue Williams, and Jack Jones. Jones manages the business, including the responsibility for the financial statements. Smith and Williams are in charge of sales and marketing. Each owner has a one-third stake in the business.

Jones recently hired his son, Paul, to manage the office. Paul has limited managerial experience, but his father hopes Paul will take over in a few years when he retires, and this is a good opportunity for Paul to learn the business.

Paul is given complete control over payroll, and he approves disbursements, signs checks, and reconciles the general ledger cash account to the bank statement balance. Previously, the bookkeeper was the only employee with such authority. However, the bookkeeper recently left the company and Jack Jones needed someone he could trust to be in charge of these sensitive operations. He did ask his son to hire someone as soon as possible to help with these and other accounting functions. Paul hired Larry Davis shortly thereafter based on a friend's recommendation. While Davis is relatively inexperienced, he did graduate with honors in Accounting from Anytown University and recently passed all parts of the CPA Exam.

On March 21, one year after hiring Davis, Paul discovered that he needed surgery. Even though the procedure was fairly common and the risks were minimal, Paul planned to take three weeks off after the surgery because of other medical conditions that might complicate the recovery. He told Davis to approve vouchers for payment and present them to his father during the three-week period for payment. Paul had previously discussed this plan with his father, and they both agreed that Davis was ready to assume the additional responsibilities. They did not, however, discuss the matter with either Smith or Williams.

The bank statement for March arrived on April 4. Paul did not tell Davis to reconcile the bank statement. In fact, he specifically told Davis to just put it aside until he returned. But Davis looked at the March statement while trying to trace a payment to a vendor who had billed the company for an invoice that Davis thought had already been paid, which was true. In the course of examining the bank statement, Davis noticed five separate payments to Paul, each for $2,000, during March. He became suspicious because Paul's salary was $3,950 per month. What's more, a check for that amount appeared on the statement.

Curiosity got the better of Davis and he decided to trace the checks paid to Paul to the cash disbursements journal. He looked for supporting documentation but couldn't find any. He noticed that the five checks were coded to different accounts including supplies, travel and entertainment, office expense, and two miscellaneous expenses. He then reviewed the banks statements for January and February and found five separate check payments each month to Paul each for $2,000.

Davis didn't know what to do at this point. He was quite certain there was no business justification for the $30,000 payments to Paul for the first three months of the year and he was concerned that if the same pattern continued unabated for the next three months, the total of $60,000 payments to Paul might threaten the ability of the company to secure a $100,000 loan for working capital.

What would you do if you were in the position of Larry Davis? Use the Integrated Ethical Decision-Making Model to craft your responses.

Ace Manufacturing: Integrated Ethical Decision-Making Process

1. Identify the ethical and professional issues (ethical sensitivity).

GAAP

- Appears there may be fraud in the financial statements. Expense accounts were charged for personal withdrawals.

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- Financial statements do not fairly present financial position and results of operations due to improper expensing of personal expenditures.
- Taxable income may be similarly misstated.

Stakeholders/Interests

- Owners including Jack Jones
- Paul Jones (son)
- Larry Davis (new accountant/CPA)
- IRS
- Banks that may be approached about the loan
- Smith and Williams were not informed of Davis's increased responsibilities during Paul's recovery.

Ethical/professional standards

- Objectivity: Davis should not permit bias or influence, because of Paul's authority position, to interfere with making the right choice.
- Integrity: Don't subordinate judgment to Paul even though he is your boss.
- Due care: Professional skepticism has been exercised; carry through diligently and insist on supporting evidence for the recorded expenditures.

2. Identify and evaluate alternative courses of action (ethical judgment).

Legal issues

- Lacking evidence to the contrary, GAAP appears to have been violated and the financial statements are fraudulent. Legal liabilities may exist.
- Tax payments will be understated assuming the improper accounting carries over to taxable income.
- Jack Jones (through his son's actions) may have some liability to the other owners.

Alternatives/ethical analysis

- Do nothing: Davis knows about the highly questionable personal withdrawals by Paul. He can't stand idly by and do nothing. That would violate the integrity standard in the AICPA Code.
- Confront Paul and insist on an explanation: (a) allow him to repay the amount if he agrees to do so, (b) insist on adjusting entries, and/or (c) bring the matter to the attention of the owners and let them deal with it.
- Report the matter to Jack Jones–let Paul's dad deal with it: He may pay back the amounts for his son, which sweeps the ethical problem under the rug; he may read the riot act to his son.
- Report the matter to all of the owners without confronting Paul. Possible outcomes: (a) Jack Jones may insist Davis should be fired; (b) The other owners may insist Paul must be fired; (c) Paul's dad makes good on the amount owed to the company by his son's wrongdoing.

Prevailing ethical theories: Rule utilitarianism dictates that certain rules should never be violated (i.e. GAAP) regardless of any utilitarian benefits. Owners have a right to know about Paul's ethical lapse. Davis has an ethical obligation to the owners to make them aware of the situation. Davis has a professional, ethical obligation to avoid subordinating his judgment to Paul and/or his father. Justice requires Paul suffer the consequences of his action. If a different employee submitted improper expenses for reimbursement, that employee would (should be) reported to top management–the owners.

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3. **Reflect on the moral intensity of the situation and virtues that enable ethical action to occur (ethical intent).**

- Do I want to be responsible for getting Paul in trouble with his dad, possibly fired? Paul may be prosecuted for his actions. The consequences for Ace are severe so I need to be sure of my decision.
- I want to do the right thing but will my actions do irreparable harm to others? What organizational pressures exist that may influence my decision?
- Can I ever trust Paul again? What he did is wrong and I shouldn't become a party to a cover-up. I need to avoid the slippery slope.
- I am accountable for my actions; I need to maintain my integrity.
- I need to avoid the effects of cognitive dissonance and not act in a manner that is inconsistent with the way I think I should act as an ethical person.
- What are my responsibilities given the company's pending bank loan?

4. **Take action (ethical behavior).**

- I should give Paul an opportunity to explain why he did what he did, out of fairness, but be prepared to approach the owners if his explanation and intended actions are not satisfactory.
- I should insist that steps be taken to correct the accounting and have the courage to stand up for my beliefs.

Giving Voice to Values

LO 2-10

Describe the "Giving Voice to Values" technique and apply it to a case study.

Once I decide what to do and why, I need to assess how best to express myself and be true to my values. I should expect Paul to come up with reasons and rationalizations for what he did. I need to be prepared to counter them using sound judgment. This is where a "Giving Voice to Values" framework comes in handy.

"Giving Voice to Values" (GVV) is a behavioral ethics approach that builds on the traditional philosophical reasoning methods and emphasizes developing the capacity to effectively express one's values to ensure ethical action is taken. There is a need to develop an approach to express one's values in a way that positively influences others by finding the levers to effectively voice and enact one's values.[92] GVV asks the protagonist to think about the arguments others might make that create barriers to expressing one's values and how best to counteract these "reasons and rationalizations."[93]

GVV links to ethical intent and ethical action in Rest's Model. An ethical decision maker should start by committing to expressing his values. The intent is there, but it may fall short of the mark of taking ethical action unless a pathway can be found to effectively express what one believes is the proper course of action in workplace dilemma situations. It is the pathway to that action that GVV addresses.

GVV is used post–decision making; that is, you have already decided what to do and have chosen to voice your values. According to Mary Gentile who developed the GVV methodology, "It shifts the focus away from awareness and analysis to action by addressing a series of questions for protagonists after identifying the right thing to do," including: How can you get it done effectively and efficiently? What do you need to say, to whom, and in what sequence? What will the objections or pushback be and, then, what will you say next? What data and examples do you need to support your point of view?[94]

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The underlying theme of GVV is that we can effectively voice values in the workplace if we have the proper tools to do so. GVV relies on developing arguments and action plans and rehearsing how to voice/enact not just any values, but moral values specifically. For our purposes, the six pillars of character and intellectual and instrumental virtues discussed in this and the previous chapter are our target behaviors.

Reasons and Rationalizations

An important part of the GVV methodology is to develop ways to confront barriers we may encounter when value conflicts exist in the workplace. These barriers often appear in the form of "reasons and rationalizations" that can confound our best attempts to fulfill our sense of organizational and personal purpose. These are the objections one might hear from colleagues when attempting to point out an ethical problem in the way things are being done, as Cynthia Cooper experienced in the WorldCom case. Or sometimes you do not hear them because they are the unspoken assumptions of the organization.[95]

GVV provides a framework to deal with the opposing points of view based on the following series of questions.[96]

- What are the main arguments you are trying to counter? That is, what are the *reasons and rationalizations* you need to address?
- What is at *stake* for the key parties, including those who disagree with you?
- What *levers* can you use to influence those who disagree with you?
- What is your most *powerful and persuasive response* to the reasons and rationalizations you need to address? To whom should the argument be made? When and in what context?

Gentile identifies the most frequent categories of argument or rationalization that we face when we speak out against unethical practice.

Expected or Standard Practice: "Everyone does this, so it's really standard practice. It's even expected."

Materiality: "The impact of this action is not material. It doesn't really hurt anyone."

Locus of Responsibility: "This is not my responsibility; I'm just following orders here."

Locus of Loyalty: "I know this isn't quite fair to the customer, but I don't want to hurt my reports/team/boss/company."

An additional argument we include is:

Isolated Incident: "This is a one-time request; you won't be asked to do it again."

Think back to Andy Fastow's "explanation" for why the financial statement amounts were manipulated by Enron and you'll see a good example of a company that readily rationalized its unethical behavior.

Ace Manufacturing: GVV Analysis

We assume that Davis has decided to give Paul a chance to explain why he is receiving $10,000 a month with coding the expenditures to different accounts and no further substantiation. Giving Paul the opportunity to explain enhances the GVV methodology because Davis needs to be prepared to counter the arguments provided by Paul.

Davis needs to find a way to communicate his values powerfully and persuasively in the face of strong countervailing organizational or individuals norms, reasons, and rationalizations. In other words, how can Davis find a way to effectively articulate his point of view so that others can be convinced of its

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rightness? He may need to find a way not only to counteract Paul's position but that of his dad as well if he provides reasons to go along with what he and Paul decide is best in this situation.

Kohlberg argues that higher moral development requires role-taking ability. Role-taking ability involves understanding the cognitive and affective (i.e., relating to moods, emotions, and attitudes) aspects of another person's point of view. Davis needs to consider how Paul might react, what he might say, and how Davis might counter those statements when he meets with Paul.

We assume Paul and Davis will meet to discuss the matter. Using the GVV framework, what follows is a brief explanation of how such a meeting might go.

What are the main arguments you are trying to counter? That is, what are the reasons and rationalizations you need to address?

These could be addressed from the perspective of Paul trying to convince Davis to remain silent about the apparent misappropriation of company cash. Developing a script, such as the one below, can help Davis get to the next step, which is to understand the full scope of his dilemma, and then develop responses to Paul and other detractors with an opposing view (i.e., his dad) followed by involving other parties that can serve as enablers for his position.

- Davis was told to put bank statements aside and not to do reconciliations.
- The company is privately owned, no one gets hurt by what he did.
- The use of company cash for personal purposes is a common practice in the company because it's not publicly owned. (*Expected or Standard Practice*)
- He needed the money to pay for hospitalization costs.
- The amount of money involved is not significant. (*Materiality*)
- His monthly salary is low for someone in his position; he's not being compensated adequately.
- It was a one-time event and won't happen again. (*Isolated Incident*)
- His dad knows about it and has approved the withdrawals.
- He promises to pay the money back as soon as he gets out of the hospital (no harm, no foul).

What is at stake for the key parties, including those who disagree with you? (Moral intensity issues exist here.)

- Paul's reputation is on the line because he committed a fraud on the company.
- Jack Jones will feel embarrassed for himself and his son if Davis discloses what Paul has done to the other owners.
- The other owners have a right to know what has happened and may feel betrayed if no one discloses the problem.
- Davis may lose his job if he confronts Paul even if he drops the matter later on.
- The ability of the company to secure the $100,000 loan is at stake.
- Davis' reputation for integrity is at stake.

What levers can you use to influence those who disagree with you?

- Davis can ask Paul for supporting documentation to back up the coding of expenses to different accounts; he can share with Paul his analysis of the bank statements. When faced with the evidence, Paul may agree to repay the amount and not do it again.

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- Davis can try to convince Paul that his actions are harmful to the company and potentially very embarrassing for his dad; he needs to come forward sooner rather than later and correct the "mistake."
- Davis can try to convince Paul that he needs to look at the long-term effects of taking money from the company that has not been properly authorized, rather than focus on short-term gain such as covering hospital bills. He certainly could have asked his dad to pay for these amounts.
- Davis should try and convince Paul of the dangers of producing financial statements with fraudulent expenses both in terms of the bank loan and taxes.
- Davis can use the leverage of threatening to go to all the owners if Paul doesn't admit the mistake and take corrective action; his loyalty obligation is to the three owners, not just Paul. They are the ones with the most at stake.
- Davis can enlist the help of Smith and Williams to serve as supporters to help counteract the reasons and rationalizations provided by Paul for his actions.
- Davis' reputation is at stake: he cannot violate the ethics of the profession; the accounting is wrong and needs to be corrected; he needs to explain about his ethical obligations as a CPA.

What is your most powerful and persuasive response to the reasons and rationalizations you need to address? To whom should the argument be made? When and in what context?

- Davis should explain to Paul that he was acting diligently when he looked at the bank statements because he didn't want to pay the same vendor twice and needed to see whether the first check had cleared the bank statement. In fact, Davis saved the company money by examining the bank statements and identifying the duplicate request for payment by a vendor.
- He should explain that using company cash for personal purposes is never acceptable unless Paul can demonstrate that the other owners knew about it and approved it.
- He should stress to Paul that taking company funds without offsetting business expenditures is a personal withdrawal, not an operating expense.
- Davis should challenge Paul's statement that his dad knows about it and approved it by suggesting they both go to Jack Jones and discuss the matter; he is calling Paul's bluff. Paul may back off at this point, which confirms the asset misappropriation.
- He should explain to Paul that it is not enough to simply pay the money back. Davis doesn't want to get caught up in a cover-up. He should ask himself: What if Paul persists in his actions even after repaying the $30,000? If he doesn't inform the owners now, Davis could be accused of being part of the problem and dismissed from his job. While this may seem remote at the time, Davis needs to ask himself: How would I feel if the state board of accountancy is contacted?

Role-playing Exercise

The script is developed and now it's time to turn it into a role-playing exercise where key participants can practice voicing their beliefs in a contentious situation.

Assume that Larry Davis calls Paul Jones and they set a 2:00 p.m. meeting on Friday at Paul's home where he is convalescing. The meeting goes like this:

"Paul, how are you feeling?"

"OK, Larry. What's happening at work?"

"That's why I wanted to see you."

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"Yeah, why's that?"

"I noticed $10,000 payments to you each month for the first three months of the year. I can't find any supporting documentation for these amounts."

Paul immediately becomes indignant. "I told you not to look at the bank statements. You ignored my orders and disrespected my position. Your job is on the line here."

Davis is taken aback. He hesitates at first but explains about the vendor billing and tells Paul he saved the company $40,000 by detecting the duplicate billing. Paul abruptly says: "Don't you think I would have found this discrepancy?" Davis can tell Paul's anger is growing so he tries to defuse the situation.

"Paul, I may have overstepped my bounds here, and I apologize, but I believe, on balance, that I did the right thing."

Paul starts to get tired and Davis can tell he's stressed out so they agree to meet in Paul's office on Monday when he returns to work.

Paul's final comment is, "Tell no one about this meeting!" Davis returns to the office and starts to reflect on the meeting. He is not sure what to do at this point. He is thinking about his options, including not waiting for the meeting with Paul before acting.

What would you do if you were in Davis's position? You might seek out some advice at this point. Perhaps you have a trusted friend or adviser who can bring a fresh perspective to the situation? *The role-playing exercise might be extended for such a discussion.*

Cognitive issues play a role in what Davis decides to do. He needs to follow a Systems 2 approach, which he has already begun to do, by carefully evaluating the possible consequences of his actions for himself and others. He knows what is the right thing to do and must be certain his actions reflect his beliefs.

Concluding Thoughts

Good intentions are a necessary but insufficient condition to ensure that ethical action occurs. You have learned in the first two chapters that an ethical person knows what the right thing to do is but can struggle doing it. Sometimes biases influence our actions and decisions. At other times, organizational pressures dissuade us from the rightful course. In the end it is a matter of conforming our beliefs with our actions.

Ethical decisions are not made in a vacuum. Pressures exist in the real world of business and accounting; cultures may support or work against ethical behavior; and individuals react differently to the reasons and rationalizations given for not taking the ethical path. Therefore, it is important to understand how best to make your case when faced with an ethical dilemma. You need to learn how to overcome obstacles and effectively deal with those who would distract you from the goal of making the ethical choice and following through with ethical action. This is where the GVV framework is most valuable.

You will face dilemmas in the workplace; all of us do. You may make some mistakes, but in truth the only mistake is not trying to correct wrongdoing. In this chapter we have tried to provide you with the tools to deal with ethical conflicts in the workplace. We've given you a pathway to serve as part of a process for making ethical decisions. Perhaps the least likely person to choose for our final inspirational quote is Kristi Loucks, a sports writer, author, and freelance pastry chef who also covers the National Hockey League team Chicago Blackhawks. Loucks has said, "The road to success is littered with failures, but the lessons learned are crucial in plotting your course to success!"

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Discussion Questions

1. Why do you think good people sometimes do bad things? Explain.
2. How do theories about the world, other people, and ourselves influence ethical decision making?
3. On November 21, 2017, a story broke that *New Yorker* reporter Ronan Farrow had alleged that Harvey Weinstein used lengthy nondisclosure agreements attached to hefty monetary settlements to prevent accusers from coming forward with reports of his alleged sexual activities. Do you think it would be right or wrong for someone who alleges Weinstein sexually harassed them to violate the nondisclosure agreement in order to get their story out in the press and potentially help other victims? Explain using ethical reasoning.
4. Back in August 2017, a leaked memo by Google employee James Damore alleged that the company was discriminating in its hiring practices based on race or gender. He claimed that Google was "pressing individual managers to increase diversity" and is "using race or gender" to decide which workers are promoted and with which teams job candidates are placed. Damore made controversial statements like: "Women, on average, have more openness directed towards their feelings and aesthetics rather than ideas. Women generally also have a stronger interest in people rather than things, relative to men . . . These two differences in part explain why women relatively prefer jobs in social or artistic areas. More men like coding because it requires systemizing and even within software engineers, comparatively more women work on the front end, which deals with both people and aesthetics." Google's CEO, Sundar Pichai, criticized the memo that claimed women had biological issues that prevented them from being as successful as men in technology. He said Damore's statements had "crossed the line by advancing harmful gender stereotypes in our workplace."[97] Damore was fired by Google after 3 1/2 years for writing the memo critical of the company's diversity efforts. Evaluate Damore's statements with respect to the discussion in this chapter of equity, diversity, and inclusion.
5. In 2016, an incident of price gouging raised issues similar to those in the Heinz and the Drug discussion in this chapter. Turing Pharmaceuticals purchased the right to the prescription drug Diaprim, a life-saving drug that treats toxoplasmosis, an infection that affects people with compromised immune systems, particularly those with HIV/AIDS and some forms of cancer. Lacking competition for their drug, Turing raised the price from $13.50 per tablet to $750 per tablet, or an increase of 5,000%. The reason given for the increase was to help the company fund its research work on toxoplasmosis, along with new education programs for the disease. Turing's CEO, Martin Shkreli, explained that it was a great business decision that benefited the company's stakeholders. From an ethical perspective, what's wrong with a pharmaceutical company charging whatever price the market will bear?
6. Do you believe all sexual relationships should be forbidden in the workplace? Use ethical reasoning to support your view.
7. How do you assess at what stage of moral development in Kohlberg's model you reason at in making decisions? Do you believe your level of reasoning is consistent with what is expected of an accounting professional? How does the stage you indicate relate to the findings of research studies discussed in this chapter about moral reasoning in accounting?
8. In his research into the components of ethical decision making, Rest raised the following issue: Assuming someone possesses sound moral reasoning skills, "Why would they ever choose the moral alternative, especially if it involves sacrificing some personal value or suffering some hardship? What motivates the selection of moral values over other values?" How does Rest's model deal with such a question? How would you answer it from the point of view of an accounting professional?

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9. In the text, we point out that Rest's model is not linear in nature. An individual who demonstrates adequacy in one component may not necessarily be adequate in another, and moral failure can occur when there is a deficiency in any one component. Give an example in accounting when ethical intent may not be sufficient to produce ethical behavior and explain why that is the case.
10. In teaching about moral development, instructors often point out the threefold nature of morality: It depends on emotional development (in the form of the ability to feel guilt or shame), social development (manifested by the recognition of the group and the importance of moral behavior for the group's existence), and cognitive development (especially the ability to adopt another's perspective). How does this perspective of morality relate to ethical reasoning by accountants and auditors?
11. Do you believe that our beliefs trigger our actions, or do we act and then justify our actions by changing our beliefs? Explain.
12. Explain why moral problems may be of greater intensity than nonmoral problems.
13. Michael just graduated with a degree in Accounting from State University. He worked hard in school but could only achieve a 2.95 GPA because he worked 40 hours a week to pay his own way through college. Unfortunately, Michael was unable to get a job because the recruiters all had a 3.0 GPA cut-off point. Michael stayed with his college job for another year but is anxious to start his public accounting career. One day he reads about a job opening with a local CPA firm. The entry-level position pays little but it's a way for Michael to get his foot in the door. However, he knows there will be candidates for the position with a higher GPA than his so he is thinking about using his overall GPA, which was 3.25 including two years of community college studies, rather than his major GPA and the GPA at State, even though the advertisement asks for these two GPAs. Michael asks for your opinion before sending in the résumé. What would you say to Michael and why?
14. In this chapter, we discuss the study by Libby and Thorne of the association between auditors' virtue and professional judgment. The most important virtues identified were truthful, independent, objective, and having integrity. The authors note that the inclusion of these virtues in professional codes of conduct (such as the Principles of the AICPA Code) may account for their perceived importance. Explain how these virtues relate to an auditor's intention to make ethical decisions.
15. You are in charge of the checking account for a small business. One morning, your accounting supervisor enters your office and asks you for a check for $150 for expenses that he tells you he incurred entertaining a client last night. He submits receipts from a restaurant and lounge. Later, your supervisor's girlfriend stops by to pick him up for lunch, and you overhear her telling the receptionist what a great time she had at dinner and dancing with your supervisor the night before. What would you do and why?
16. According to a survey reported by the *Daily Mail* in the United Kingdom, one in eight women has bought expensive clothes, worn them on a night out, and then returned them the next day. Nearly half of those who did confess said they were motivated by money because they couldn't afford to keep the clothes given their current economic condition. But 18% said they did it because they enjoyed the "buzz." Those most likely to do it were 18- to 24-year-olds, 16% of whom admitted to returning worn clothes.[98]

    Assume you are best friends with one such woman. She asks you to go shopping with her for a dress for the Senior Prom. She says the dress will be returned after the prom. What would you do or say to your friend and why? How might you counter the likely reasons and rationalizations she will give for her actions?
17. Sharon is an intern with a local CPA firm. Prior to returning to school, her supervisor goes on sick leave and asks her to do some complicated reconciliation work for him. She is given what seems to her to be an unrealistic deadline. Sharon looks at the workpapers and supporting documentation

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and realizes she doesn't have the skills to complete the work without help. She contacts her supervisor who tells her to talk to Holly, a good friend of Sharon and former intern at the firm, for help. Holly returned to school one semester ago. What ethical considerations do you have in this matter? What would you do and why?

18. Identify the ethical issues in each of the following situations and what your ethical obligations are, assuming you are faced with the dilemma.
    a. A consultant for a CPA firm is ordered by her superior to downgrade the ratings of one company's software package being considered for a client and increase the ratings for another company, which is run by the superior's wife. What would you do and why?
    b. A tax accountant is told by his superior to take a position on a tax matter that is not supportable by the facts in order to make the client happy. This is a common practice in the firm and the likelihood of the IRS questioning it is remote. Would you go along with your supervisor?
    c. An auditor for a governmental agency concluded a contractor's accounting system was inadequate; her supervisor changed the opinion to adequate in order to minimize the audit hours on the job and make the process seem more efficient. Would you go above your supervisor in this matter and bring your concerns to high-ups in the agency?
19. One expression in particular seems to sum up why the accounting frauds at companies such as Enron, WorldCom, and HealthSouth were allowed to persist for so long: "If I Do It, I Must Do It Again." Explain what is meant by this statement in the context of ethical decision making.
20. Explain why the process of ethical decision making depends on a number of moral, social, psychological, and organizational factors.
21. Select one of the rationalizations for Enron's actions identified by Andy Fastow in the chapter opening and explain how you would counteract that statement by emphasizing its ethical deficiencies.
22. Windsor and Kavanagh propose in a research study that client management economic pressure is a situation of high moral intensity that sensitizes auditors' emotions and thus motivates their moral reasoning to make deliberative decisions either to resist or accede to client management wishes. Explain how you think such a process might work.
23. Explain how an overconfidence bias might influence an auditor's judgment about the proper balance sheet value of inventory?
24. Explain what you think each of the following statements means in the context of moral development.
    a. How far are you willing to go to do the right thing?
    b. How much are you willing to give up to do what you believe is right?
    c. We may think we would blow the whistle on client wrongdoing but what should we do if firm management tells us to drop the matter?
25. A major theme of this chapter is that our cognitive processes influence ethical decision making. Use the theme to comment on the following statement, which various religions claim as their own and has been attributed to Lao Tzu and, some say, the Dalai Lama:

    "Watch your thoughts; they become your words.

    Watch your words; they become your actions.

    Watch your actions; they become your habits.

    Watch your habits; they become your character.

    Watch your character; it becomes your destiny."

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Chapter 2 Cases

Case 2-1 A Team Player? (a GVV case)

Barbara is working on the audit of a client with a group of five other staff-level employees. After the inventory audit was completed, Diane, a member of the group, asks to meet with the other employees. She points out that she now realizes a deficiency exists in the client's inventory system whereby a small number of items were double counted. The amounts are relatively minor and the rest of the inventory observation went smoothly. Barbara suggests to Diane that they bring the matter to Jessica, the senior in charge of the engagement. Diane does not want to do it because she is the one responsible for the oversight. Three of the other four staff members agree with Diane. Haley is the only one, along with Barbara, who wants to inform Jessica.

After an extended discussion of the matter, the group votes and decides not to inform Jessica. Still, Barbara does not feel right about it. She wonders: What if Jessica finds out another way? What if the deficiency is more serious than Diane has said? What if it portends other problems with the client? She decides to raise all these issues but is rebuked by the others who remind her that the team is already behind on its work and any additional audit procedures would increase the time spent on the audit and make them all look incompetent. They remind Barbara that Jessica is a stickler for keeping to the budget and any overages cannot be billed to the client.

Questions

1. Explain how cognitive shortcomings play a role in Diane's position.
2. Explain what Barbara should do if she reasons at each of the six stages of Kohlberg's model.
3. Assume you are in Barbara's position. What would you do and why? Consider the following in answering the question:

- How can you best express your point of view effectively?
- What do you need to say, to whom, and in what sequence?
- What do you expect the objections or pushback will be and, then, what would you say next?

Case 2-2 FDA Liability Concerns (a GVV case)

Gregory and Alex started a small business based on a secret-recipe salad dressing that got rave reviews. Gregory runs the business end and makes all final operational decisions. Alex runs the creative side of the business.

Alex's salad dressing was a jalapeno vinaigrette that went great with barbeque or burgers. He got many requests for the recipe and a local restaurant asked to use it as the house special, so Alex decided to bottle and market the dressing to the big box stores. Whole Foods and Trader Joe's carried the dressing; sales were increasing every month. As the business grew, Gregory and Alex hired Michael, a college friend and CPA, to be the CFO of the company.

Michael's first suggestion was to do a five-year strategic plan with expanding product lines and taking the company public or selling it within five to seven years. Gregory and Alex weren't sure about wanting to go public and losing control, but expanding the product lines was appealing. Michael also wanted to contain costs and increase profit margins.

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At Alex's insistence, they called a meeting with Michael to discuss his plans.

"Michael, we hired you to take care of the accounting and the financial details," Alex said. "We don't understand profit margins. On containing costs, the best ingredients must be used to ensure the quality of the dressing. We must meet all FDA requirements for food safety and containment of food borne bacteria, such as listeria or e. coli, as you develop cost systems."

"Of course," Michael responded. "I will put processes in place to meet the FDA requirements."

At the next quarterly meeting of the officers, Alex wanted an update on the FDA processes and the latest inspection. He was concerned whether Michael understood the importance of full compliance.

"Michael," Alex said, "the FDA inspector and I had a discussion while he was here. He wanted to make sure I understood the processes and the liabilities of the company if foodborne bacteria are traced to our products. Are we doing everything by the book and reserving some liabilities for any future recalls?"

Michael assured Alex and Gregory that everything was being done by the book and the accounting was following standard practices. Over the next 18 months, the FDA inspectors came and Michael reported everything was fine.

After the next inspection, there was some listeria found in the product. The FDA insisted on a recall of batch 57839. Alex wanted to recall all the product to make sure that all batches were safe.

"A total recall is too expensive and would mean that the product could be off the shelves for three to four weeks. It would be hard to regain our shelf advantage and we would lose market share," Michael explained.

Alex seemed irritated and turned to Gregory for support, but he was silent. He then walked over to where Michael was sitting and said, "Michael, nothing is more important than our reputation. Our promise and mission is to provide great-tasting dressing made with the freshest, best, organic products. A total recall will show that we stand by our mission and promise. I know we would have some losses, but don't we have a liability reserve for recall, like a warranty reserve?"

"The reserve will not cover the entire expense of a recall," Michael said. "It will be too expensive to do a total recall and will cause a huge loss for the quarter. In the next six months, we will need to renew a bank loan; a loss will hurt our renewal loan rate and terms. You know I have been working to get the company primed to go public as well."

Alex offered that he didn't care about going public. He didn't start the business to be profitable. Gregory, on the other hand, indicated he thought going public was a great idea and would provide needed funds on a continuous basis.

Alex told Michael that he needed to see all the FDA inspection reports. He asked, "What is the FDA requiring to be done to address the issue of listeria?"

"I'm handling it, Alex," Michael said. "Don't worry about it. Just keep making new salad dressings so that we can stay competitive."

"Well, Michael, just answer what the FDA is asking for."

"Just to sterilize some of our equipment, but it shouldn't be too bad."

"Michael, it's more than that," Alex responded. "The FDA contacted me directly and asked me to meet with them in three days to discuss our plans to meet the FDA requirements and standards. We will be fined for not addressing issues found in prior inspections. I want to see the past inspection reports so I can better understand the scope of the problem."

"Listen, Alex," Michael said. "I just completed a cost–benefit analysis of fixing all the problems identified by the FDA and found the costs outweighed the benefits. We're better off paying whatever fines they impose and move on."

"Michael, I don't care about cost–benefit analysis. I care about my reputation and that of the company. Bring me all the inspection reports tomorrow."

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The three of them met the following day. As Alex reviewed the past inspection reports, he realized that he had relied on Michael too much and his assurances that all was well with the FDA. In fact, the FDA had repeatedly noted that more sterilization of the equipment was needed and that storage of the products and ingredients needed additional care. Alex began to wonder whether Michael should stay on with the company. He also was concerned about the fact that Gregory had been largely silent during the discussions. He wondered whether Gregory was putting profits ahead of safety and the reputation of the company.

Questions

Alex knows what the right thing to do is. As Alex prepares for a meeting on the inspection reports the next day, he focuses on influencing the positions of Michael and Gregory, both of whom will be involved in the meeting. Put yourself in Alex's position and answer the following questions.

1. What are the main arguments you are trying to counter? That is, what are the reasons and rationalizations you need to address?
2. What is at stake for the key parties, including those who disagree with you?
3. What levers can you use to influence those who disagree with you?
4. What is your most powerful and persuasive response to the reasons and rationalizations you need to address? To whom should the argument be made? When and in what context?

Case 2-3 Taxes and the Cannabis Business (a GVV case)

Hailey Declaire, a CPA, just sent the tax return that she prepared for a client in the marijuana growing and distribution business, Weeds 'R' Us, to Harry Smokes the manager of the tax department. Harry had just fielded a phone call from the president of Weeds 'R' Us who gave him an ear full because Hailey insisted on reporting all of the cash sales from the marijuana business on the 2019 tax return. Hailey arrives at Harry's office and the following conversation ensues.

"Hailey, come in," Harry said.

"Thank you, Harry," Hailey responded.

"Do you know why I asked to see you?"

"I'm not sure. Does it have something to do with the tax return for Weeds 'R' Us?" asked Hailey.

"That's right," answered Harry.

"Is there a problem?" Hailey asked.

Harry answered: "I just spoke with the company's president. He said you insisted on reporting 100% of the cash sales from the marijuana business. He's upset. He wants to hold back 25% of that amount and figures no one will be the wiser because marijuana is a cash business. The company can't get a bank account in the state because, even though the cannabis business is legal in the state, it still is prohibited under federal law under the Controlled Substances Act."

"Why would we risk our reputation by going along with the client's position?" Hailey asked.

"It's not that simple," Harry responded. "The client needs an audit report under state regulations. We have been pushing hard to get that business. It's lucrative and may open the door to even more services including personal financial planning."

Harry knew he could simply change the tax return and submit it for the client. However, he wanted Hailey to get onboard because the firm intended to go after other clients in the marijuana business. So, Harry asked Hailey to

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meet with him and the partner in charge of the tax practice first thing on Monday morning. Hailey says she'll be there and returns to her office.

Questions

Assume you are in Hailey's position and answer the following questions.

1. Explain how social and organizational pressures might influence your position at Monday's meeting.
2. What role might cognitive dissonance play in developing your position?
3. Think of your response in the context of developing a script and consider the following:
   - What are the main arguments you are trying to counter? That is, what are the reasons and rationalizations you need to address?
   - What is at stake for the key parties?
   - What levers can you use to influence those who disagree with you?
   - What is your most powerful and persuasive response to the reasons and rationalizations you need to address? To whom should the argument be made? When and in what context?

Case 2-4 A Faulty Budget (a GVV Case)

Jackson Daniels graduated from Lynchberg State College two years ago. Since graduating from college, he has worked in the accounting department of Lynchberg Manufacturing. Lynchberg is publicly-owned with an eleven-member board of directors.

Daniels was recently asked to prepare a sales budget for the year 2019. He conducted a thorough analysis and came out with projected sales of 250,000 units of product. That represents a 25% increase over 2018.

Daniels went to lunch with his best friend, Jonathan Walker, to celebrate the completion of his first solo job. Walker noticed Daniels seemed very distant. He asked what the matter was. Daniels stroked his chin, ran his hand through his bushy, black hair, took another drink of scotch, and looked straight into the eyes of his friend of 20 years. "Jon, I think I made a mistake with the budget."

"What do you mean?" Walker answered.

"You know how we developed a new process to manufacture soaking tanks to keep the ingredients fresh?"

"Yes," Walker answered.

"Well, I projected twice the level of sales for that product than will likely occur."

"Are you sure?" Walker asked.

"I checked my numbers. I'm sure. It was just a mistake on my part."

Walker asked Daniels what he planned to do about it.

"I think I should report it to Pete. He's the one who acted on the numbers to hire additional workers to produce the soaking tanks," Daniels said.

"Wait a second, Jack. How do you know there won't be extra demand for the product? You and I both know demand is a tricky number to project, especially when a new product comes on the market. Why don't you sit back and wait to see what happens?"

"Jon, I owe it to Pete to be honest. He was responsible for my hire."

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"You know Pete is always pressuring us to 'make the numbers.' Also, Pete has a zero tolerance for employees who make mistakes. That's why it's standard practice around here to sweep things under the rug. Besides, it's a one-time event—right?"

"But what happens if I'm right and the sales numbers were wrong? What happens if the demand does not increase beyond what I now know to be the correct projected level?"

"Well, you can tell Pete about it at that time. Why raise a red flag now when there may be no need?"

As the lunch comes to a conclusion, Walker pulls Daniels aside and says, "Jack, this could mean your job. If I were in your position, I'd protect my own interests first."

Jimmy (Pete) Beam is the vice president of production. Jackson Daniels had referred to him in his conversation with Jonathan Walker. After several days of reflection on his friend's comments, Daniels decided to approach Pete and tell him about the mistake. He knew there might be consequences, but his sense of right and wrong ruled the day. What transpired next surprised Daniels.

"Come in, Jack" Pete said.

"Thanks, Pete. I asked to see you on a sensitive matter."

"I'm listening."

"There is no easy way to say this so I'll just tell you the truth. I made a mistake in my sales budget. The projected increase of 25% was wrong. I checked my numbers and it should have been 12.5%. I'm deeply sorry, want to correct the error, and promise never to do it again."

Pete's face became beet red. He said, "Jack, you know I hired 20 new people based on your budget."

"Yes, I know."

"That means ten have to be laid off or fired. They won't be happy and once word filters through the company, other employees may wonder if they are next."

"I hadn't thought about it that way."

"Well, you should have." Here's what we are going to do . . . and this is between you and me. Don't tell anyone about this conversation."

"You mean not even tell my boss?"

"No," Pete said. "JB can't know about it because he's all about correcting errors and moving on. Look, Jack, it's my reputation at stake here as well."

Daniels hesitated but reluctantly agreed not to tell the controller, JB, his boss. The meeting ended with Daniels feeling sick to his stomach and guilty for not taking any action.

Questions

1. What are Daniels's options in this situation? Use ethical reasoning to identify the best alternative. What would you do if you were in Daniels' position?

   Assume that you have decided to take some action, based on the ethical analysis, even though you had agreed not to do so. Consider the following in deciding what your next step should be.

2. What is at stake for the key parties?
3. Based on your chosen action, develop a list of the main arguments you are likely to encounter in making the strongest case possible to the relevant stakeholders?
4. What is your most powerful and persuasive response to the reasons and rationalizations you may need to address? To whom should the argument be made? When and in what context?

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Case 2-5 Gateway Hospital

Troy just returned from a business trip for health-care administrators in Orlando. Kristen, a relatively new employee who reports to him, also attended the conference. They both work for Gateway Hospital, a for-profit hospital in the St. Louis area. The Orlando conference included training in the newest reporting requirements in the health-care industry, networking with other hospital administrators, reports on upcoming legislation in health care, and the current status of regulations related to the Affordable Care Act. The conference was in late March and coincided with Troy's kids' spring break, so the entire family traveled to Orlando to check out Walt Disney World and SeaWorld.

The hospital's expense reimbursement policy is very clear on the need for receipts for all reimbursements. Meals are covered for those not provided as part of the conference registration fee, but only within a preset range. Troy has never had a problem following those guidelines. However, the trip to Orlando was more expensive than Troy expected. He did not attend all sessions of the conference in order to enjoy time with his family. Upon their return to St. Louis, Troy's wife suggested that Troy submit three meals and one extra night at the hotel as business expenses, even though they were personal expenses. Her rationale was that the hospital policies would not totally cover the business costs of the trip. Troy often has to travel and misses family time that cannot be recovered or replaced. Troy also knows that his boss has a reputation of signing forms without reading or careful examination. He realizes the amount involved is not material and probably won't be detected.

Kristen is approached by Joyce, the head of the accounting department, about Troy's expenses, which seem high and not quite right. Kristen is asked about the extra night because she did not ask for reimbursement for that time. Kristen knows it can be easily explained by saying Troy had to stay an extra day for additional meetings, a common occurrence for administrators, although that was not the case. She also knows that the hospital has poor controls and a culture of "not rocking the boat," and that other employees have routinely inflated expense reports in the past.

Assume you, as Kristen, have decided the best approach, at least in the short run, is to put off responding to Joyce so that you can consider the matter further.

Questions

1. Should you discuss the matter first with Troy before responding to Joyce? Explain.
2. Assume Kristen is a Certified Management Accountant and member of the Institute of Management Accountants. As such, she falls under The IMA Statement of Ethical and Professional Practice. Discuss how these ethical provisions should affect what Kristen decides to do in the context of the Integrated Ethical Decision-Making Process.
3. Apply each of the four steps of the Integrated Ethical Decision-Making Process to help you decide what your course of action should be.

Case 2-6 The Normalization of Unethical Behavior: The Harvey Weinstein Case

On October 5, 2017, New York Times investigative reporters Jodi Kantor and Megan Twohey broke the story 'Harvey Weinstein Paid Off Sexual Harassment Accusers for Decades.'[1] Harvey Weinstein was one of the most powerful and influential movie executives in Hollywood. Weinstein co-founded both the Weinstein Company and

[1]Jodi Kantor and Megan Twohey, Harvey Weinstein Paid Off Sexual Harassment Accusers for Decades. *New York Times* October 5, 2017: https://www.nytimes.com/2017/10/05/us/harvey-weinstein-harassment-allegations.html.

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Miramax Films. His movies have garnered over 300 Oscar nominations. Ronan Farrow suggests in his article, 'From Aggressive Overtures To Sexual Assault: Harvey Weintein's Accusers Tell Their Stories,' that Weinstein has been publicly thanked at award ceremonies more than anyone else in movie history (with the exception of Steven Spielberg and God).[2] The allegations against Weinstein span three decades and range from sexual harassment to sexual assault and rape.

Kantor's and Twohey's report found at least eight women in which Weinstein entered into settlement agreements with to presumably keep from pursuing any further legal action against him. The release of this article resulted in a flood of women coming forward and telling their stories regarding similar encounters with Weinstein. It also led to the resignation of four of the Weinstein Companies Board members and the firing of Weinstein himself. NPR interviewed Kantor and Twohey about their investigation of Weinstein and is available via podcast.[3]

On October 10, 2017, The New Yorker published Farrow's article, which corroborates what is in the report of Kantor and Twohey with three of the thirteen women he interviewed accusing Weinstein of rape. As with the Kantor and Twohey article, Farrow suggests that Weinstein's exploits were common knowledge throughout the entertainment industry. They point toward a systemic problem in the industry where people turned a blind eye to what was happening and even normalized this behavior in their responses to it. In fact, Seth MacFarlane while announcing the Best Supporting Actress Nomination's at the 2013 Oscars joked "Congratulations, you five ladies no longer have to pretend to be attracted to Harvey Weinstein."[4]

One of the first women to be interviewed was Ashley Judd. The actress was interviewed by ABC News' Diane Sawyer about her experiences. She expressed regret that she didn't come forward sooner about her allegations of sexual harassment in a hotel room years ago from Weinstein. In the segment that first aired on ABC's "Good Morning America," Judd said she wished she had a "magic wand" that would allow her to change the past, for her and others. "I wish I could prevent it for anyone, always." Judd did tell her parents and other people in Hollywood, including agents and actors, but didn't think she would be believed by going public. "Who was I to tell," she said. "I knew it was disgusting. Was I going to tell the concierge who sent me up to the room?"[5]

Emboldened by what had become a scandal of epic proportions in the entertainment industry, dozens of women started to speak out and tell their story. It motivated actress Alyssa Milano to tweet a call-out to victims "so we might give people a sense of the magnitude of the problem." The hashtag #MeToo caught fire and became the rallying cry for all women similarly abused.

The bravery exhibited by these women empowered other women throughout the entertainment industry, media, and politics to step forward and finally tell their stories about gender sexual harassment, bullying, and rape. Time magazine named these brave women the 2017 Person(s) of the Year "Silence Breakers – the voices that launched a movement." Over the rest of 2017, we witnessed an unprecedented number of men being accused of and fired or being forced to resign because of sexual harassment allegations. These include the firing of CBS Good Morning America's host Charlie Rose, NBC's News Anchor Matt Lauer, PBS's Tavis Smiley, and a host of other high-profile media figures. Congress had its own problems with the resignation of Rep. John Conyers Jr. (D-MI.) and Senator Al Franken (D-MN).

[2]Ronan Farow, From Aggressive Overtures To Sexual Assault: Harvey Weinstein's Accusers Tell Their Stories. *The New Yorker,* October 10, 2017: https://www.newyorker.com/news/news-desk/from-aggressive-overtures-to-sexual-assault-harvey-weinsteins-accusers-tell-their-stories.

[3]https://www.npr.org/2017/11/15/564310240/times-reporters-describe-how-a-paper-trail-helped-break-the-weinstein-story.

[4]Ashley Lee, Seth MacFarlane Explains 2013 Oscars Jab at "Abhorrent, Indefensible" Harvey Weinstein, *The Hollywood Reporter,* October 11, 2017, https://www.hollywoodreporter.com/news/seth-macfarlane-explains-harvey-weinstein-at-2013-oscars-jab-1047829.

[5]Cynthia Littleton, Ashley Judd Gives First TV Interview on Harvey Weinstein: 'I Had No Warning.', October 26, 2017, http://variety.com/2017/biz/news/ashley-judd-harvey-weinstein-good-morning-america-diane-sawyer-1202599726/.

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Questions

1. Why do you think this type of behavior was allowed to go on for nearly thirty years?
2. What biases do you think may have played a role in the decisions made by both victims and others who were aware of Weinstein's crimes but did nothing?
3. What responsibility did the Weinstein board of directors have to the victims? What about agents who continued to send their clients to meetings with him? What about the Screen Actors Guild-American Federation of Television and Radio Artists (SAG-AFTRA) that claims to have a zero-tolerance policy on sexual harassment?
4 Is it fair to judge a person on his/her worst act after a lifetime of seemingly doing good things?

Case 2-7 Milton Manufacturing Company

Milton Manufacturing Company produces a variety of textiles for distribution to wholesale manufacturers of clothing products. The company's primary operations are located in Long Island City, New York, with branch factories and warehouses in several surrounding cities. Milton Manufacturing is a closely held company, and Irv Milton is the president. He started the business in 2008, and it grew in revenue from $500,000 to $5 million in 10 years. However, the revenues declined to $4.5 million in 2018. Net cash flows from all activities also were declining. The company was concerned because it planned to borrow $20 million from the credit markets in the fourth quarter of 2019.

Irv Milton met with Ann Plotkin, the chief accounting officer (and also a CPA), on January 15, 2019, to discuss a proposal by Plotkin to control cash outflows. He was not overly concerned about the recent decline in net cash flows from operating activities because these amounts were expected to increase in 2019 as a result of projected higher levels of revenue and cash collections. However, that was not Plotkin's view.

Plotkin knew that if overall negative capital expenditures continued to increase at the rate of 40% per year, Milton Manufacturing probably would not be able to borrow the $20 million. Therefore, she suggested establishing a new policy to be instituted on a temporary basis. Each plant's capital expenditures for 2019 for investing activities would be limited to the level of those capital expenditures in 2017, the last year of an overall positive cash flow. Operating activity cash flows had no such restrictions. Irv Milton pointedly asked Plotkin about the possible negative effects of such a policy, but in the end, he was convinced that it was necessary to initiate the policy immediately to stem the tide of increases in capital expenditures. A summary of cash flows appears in Exhibit 1.

Sammie Markowicz is the plant manager at the headquarters in Long Island City. He was informed of the new capital expenditure policy by Ira Sugofsky, the vice president for operations. Markowicz told Sugofsky that the new policy could negatively affect plant operations because certain machinery and equipment, essential to the production process, had been breaking down more frequently during the past two years. The problem was primarily with the motors. New and better models with more efficient motors had been developed by an overseas supplier. These were expected to be available by April 2019. Markowicz planned to order 1,000 of these new motors for the Long Island City operation, and he expected that other plant managers would do the same. Sugofsky told Markowicz to delay the acquisition of new motors for one year, after which time the restrictive capital expenditure policy would be lifted. Markowicz reluctantly agreed.

Milton Manufacturing operated profitably during the first six months of 2019. Net cash inflows from operating activities exceeded outflows by $1,250,000 during this time period. It was the first time in two years that there was a positive cash flow from operating activities. Production operations accelerated during the third quarter as a result of increased demand for Milton's textiles. An aggressive advertising campaign initiated in late 2018 seemed to bear fruit for the company. Unfortunately, the increased level of production put pressure on the machines, and the degree of breakdown was increasing. A big problem was that the motors wore out prematurely.

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EXHIBIT 1 Milton Manufacturing Company

Summary of Cash Flows
For the Years Ended December 31, 2018 and 2017 (000 omitted)

	December 31, 2018	December 31, 2017
Cash Flows from Operating Activities		
Net income	$ 372	$ 542
Adjustments to reconcile net income to net cash provided by operating activities	(2,350)	(2,383)
Net cash provided by operating activities	$(1,978)	$ (1,841)
Cash Flows from Investing Activities		
Capital expenditures	$(1,420)	$ (1,918)
Other investing inflows (outflows)	176	84
Net cash used in investing activities	$(1,244)	$ (1,834)
Cash Flows from Financing Activities		
Net cash provided (used in) financing activities	$ 168	$ 1,476
Increase (decrease) in cash and cash equivalents	$(3,054)	$ (2,199)
Cash and cash equivalents—beginning of the year	$ 3,191	$ 5,390
Cash and cash equivalents—end of the year	$ 147	$ 3,191

Markowicz was concerned about the machine breakdown and increasing delays in meeting customer demands for the shipment of the textile products. He met with the other branch plant managers, who complained bitterly to him about not being able to spend the money to acquire new motors. Markowicz was very sensitive to their needs. He informed them that the company's regular supplier had recently announced a 25% price increase for the motors. Other suppliers followed suit, and Markowicz saw no choice but to buy the motors from the overseas supplier. That supplier's price was lower, and the quality of the motors would significantly enhance the machines' operating efficiency. However, the company's restrictions on capital expenditures stood in the way of making the purchase.

Markowicz approached Sugofsky and told him about the machine breakdowns and the concerns of other plant managers. Sugofsky seemed indifferent but reminded Markowicz of the capital expenditure restrictions in place and that the Long Island City plant was committed to keeping expenditures at the same level as it had in 2017. Markowicz argued that he was faced with an unusual situation and he had to act now. Sugofsky hurriedly left, but not before he said to Markowicz, "You and I may not agree with it, but a policy is a policy."

Markowicz reflected on his obligations to Milton Manufacturing. He was conflicted because he viewed his primary responsibility and that of the other plant managers to ensure that the production process operated smoothly. The last thing the workers needed right now was a stoppage of production because of machine failure.

At this time, Markowicz learned of a 30-day promotional price offered by the overseas supplier to gain new customers by lowering the price for all motors by 25%. Coupled with the 25% increase in price by the company's supplier, Markowicz knew he could save the company $1,500, or 50% of cost, on each motor purchased from the overseas supplier.

After carefully considering the implications of his intended action, Markowicz contacted the other plant managers and informed them that, while they were not obligated to follow his lead because of the capital

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expenditure policy, he planned to purchase 1,000 motors from the overseas supplier for the headquarters plant in Long Island City.

Markowicz made the purchase at the beginning of the fourth quarter of 2019 without informing Sugofsky. He convinced the plant accountant to record the $1.5 million expenditure as an operating (not capital) expenditure because he knew that the higher level of operating cash inflows resulting from increased revenues would mask the effect of his expenditure. In fact, Markowicz was proud that he had "saved" the company $1.5 million, and he did what was necessary to ensure that the Long Island City plant continued to operate.

The acquisitions by Markowicz and the other plant managers enabled the company to keep up with the growing demand for textiles, and the company finished the year with record high levels of profit and net cash inflows from all activities. Markowicz was lauded by his team for his leadership. The company successfully executed a loan agreement with Second Bankers Hours & Trust Co. The $20 million borrowed was received on October 3, 2019.

During the course of an internal audit of the 2019 financial statements, Beverly Wald, the chief internal auditor (and also a CPA), discovered that there was an unusually high number of motors in inventory. A complete check of the inventory determined that $1 million worth of motors remained on hand.

Wald reported her findings to Ann Plotkin, and together they went to see Irv Milton. After being informed of the situation, Milton called in Sugofsky. When Wald told him about her findings, Sugofsky's face turned beet red. He told Wald that he had instructed Markowicz *not* to make the purchase. He also inquired about the accounting since Wald had said it was wrong.

Wald explained to Sugofsky that the $1 million should be accounted for as inventory, not as an operating cash outflow: "What we do in this case is transfer the motors out of inventory and into the machinery account once they are placed into operation because, according to the documentation, the motors added significant value to the asset."

Sugofsky had a perplexed look on his face. Finally, Irv Milton took control of the accounting lesson by asking, "What's the difference? Isn't the main issue that Markowicz did not follow company policy?" The three officers in the room nodded their heads simultaneously, perhaps in gratitude for being saved the additional lecturing. Milton then said he wanted Wald and Plotkin to discuss the alternatives on how best to deal with the Markowicz situation and present the choices to him in one week.

Questions

Use the Integrated Ethical Decision-Making Process to guide you in answering the following:

1. Identify the ethical and professional issues of concern to Beverly Wald and Ann Plotkin.
2. Identify and evaluate alternative courses of action using ethical reasoning.
3. Explain how the moral intensity of the situation might influence ethical action.
4. Decide on a course of action to present to Milton. Why did you select that alternative?

Case 2-8 Juggyfroot (a GVV case)

"I'm sorry, Lucy. That's the client's position," Ricardo said.

"I just don't know if I can go along with it, Ricardo," Lucy replied.

"I know. I agree with you. But, Juggyfroot is our biggest client, Lucy. They've warned us that they will put the engagement up for bid if we refuse to go along with the reclassification of marketable securities," Ricardo explained.

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"Have you spoken to Fred and Ethel about this?" Lucy asked.

"They recommended giving in to the client on this matter," Ricardo responded.

"Listen," Lucy said. "I understand the pressures of being an engagement partner and the need to keep the client happy, but this goes too far."

The previous scene took place in the office of Deziloo LLP, a large CPA firm in Beverly Hills, California. Lucy is the manager of the engagement of Juggyfroot, a publicly owned global manufacturer of pots and pans and other household items. Ricardo is the managing partner of the office. Fred and Ethel are the engagement review partners that make final judgments on difficult accounting issues, especially when there is a difference of opinion with the client. All four are CPAs.

Ricardo is preparing for a meeting with Norman Baitz, the CEO of Juggyfroot. Ricardo knows that the company expects to borrow $5 million next quarter and it wants to put the best possible face on its financial statements to impress the banks. That would explain why the company reclassified a $2 million market loss on a trading investment to the available-for-sale category so that the "loss" would now show up in stockholder's equity, not as a charge against current income. The result was to increase earnings in 2018 by 8%. Ricardo knows that without the change, the earnings would have declined by 2% and the company's stock price would have taken a hit.

In the meeting, Ricardo decides to overlook the recommendation by Fred and Ethel. He felt Lucy made valid points. Ricardo points out to Baitz that the investment in question was marketable, and in the past, the company had sold similar investments in less than one year. Ricardo adds there is no justification under GAAP to change the classification from trading to available-for-sale.

What happened next shocked Ricardo back to reality. The conversation between Baitz and Ricardo went this way.

"I hate to bring it up, Ricardo, but do you recall what happened last year at about the same time?"

"What do you mean?"

"You agreed that we could record $1 million as revenue for 2017 based on a sale of our product that we held at an off-site distribution warehouse until the client asked for delivery, which occurred in 2018."

Ricardo remembered all too well. It almost cost the firm the Juggyfroot account. "Are you going to throw that in my face?"

"No, Ricardo. Just a gentle reminder that you had agreed to go along with what we had asked at that time. We believe there is enough gray area to do the same here. Who knows. We may hold on to the investment for more than one year."

The meeting broke up when Baitz received a confidential phone call. They agreed to continue it first thing in the morning. Baitz's parting words were "we value loyalty in our accountants."

Questions

1. Explain how incrementalism might influence Ricardo's position with respect to the not so subtle statement by Norman Baitz.
2. Assume you are in Ricardo's position and preparing for the meeting with Baitz in the morning. Consider the following in crafting a response to Baitz.
   - What are the main arguments you are trying to counter?
   - What is at stake for the key parties?
   - What levers can you use to influence Baitz?
   - What is your most powerful response to the reasons and rationalizations you need to address? To whom should the argument be made? When and in what context?

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Case 2-9 Racially Charged Language Inhibits Inclusive Cultures

Leaving home for the first time and going off to college is an exciting and stressful time for tens of thousands of students across the U.S. each year. Leaving the familiarity of family, friends, and community behind and entering an often much more diverse community filled with people with different social, political, religious, racial, national, and sexual orientation backgrounds can create challenges. Luckily, there is currently an effort across the United States to reduce the impact of potential biases by educating people on and promoting the benefits of having diversity in communities, businesses, schools, and social groups people belong to. These efforts are more commonly known as Equity, Diversity, and Inclusion (EDI) Initiatives. One example of a college that seems to have it right with respect to EDI policies is the University of Wisconsin, Eau Claire. A brief review of those policies and programs appear in Exhibit 1.

EXHIBIT 1 Equity, Diversity, and Inclusion Policies and Programs at UWEC

Faculty and staff at the University of Wisconsin, Eau Claire (UWEC) have incorporated EDI initiatives into their core mission. The core mission is to create an inclusive community where all students thrive and find the programs and support needed to reach their full potential. Too often, members of underrepresented groups feel alienated and/or are unconsciously or consciously discriminated against resulting in them transferring schools or dropping out completely.

To operationalize this mission, the faculty, staff, and administration came together setting goals surrounding student enrollment and retainment specifically for underrepresented groups. The faculty have common language surrounding EDI within all course syllabi and encourage all their students to help make the classroom environment more welcoming and inclusive to all. They have all agreed to participate in EDI initiatives in some way and to have that participation be a part of their annual performance review. In 2017, they created the first office of EDI and hired an Assistant Chancellor of Equity, Diversity, and Inclusion to lead the effort.

UWEC has also developed a 12-week training program called Circles of Change to start an open in-person dialogue about race throughout the region the university is located within. Launched as a pilot in the Spring of 2017, the fall of 2017 had more than 120 people participating in Circles of Change action groups, gathering weekly to discuss race relations on campus and in the community. “The goal is to help make the Chippewa Valley a more welcoming place for everyone.”

As discussed in Chapter 2, some people have unconscious biases and stereotypical beliefs that can lead to making poor decisions. This can be magnified by instances of bias on college campuses. Many colleges and universities across the country have implemented freshman orientation programs to help students transition into college life and to make them feel welcome.

There is a need for diversity and inclusivity training. During 2017, there were many reported instances of racial bias through the use of racial slurs on college and university campuses. Many were reported during the September to December 2017 period, magnifying the growing need for EDI programs on campus. The following examples were chosen not only to illustrate the hateful speech but to describe admirable responses by the universities affected.

1. At Eastern Michigan University, racial fliers promoting a white supremacist organization were found posted on several buildings. Officials removed them because they ran counter to the school’s values. According to a spokesperson, “The fliers and the hateful, racist causes they promote run completely counter to Eastern’s core values of diversity, inclusiveness and respect.”[1]
2. At Cabrini University in Radnor, PA, a number of instances were reported of the words “N-word go away” written on the dormitory room door of a female black student and a second occurrence stating “go away too” just a

[1]https://www.freep.com/story/news/2017/09/07/racist-fliers-found-removed-eastern-michigan-university/644473001/.

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few days later. The reaction of the university was: "As we ensure a thorough investigation into the incident, we want to remind everyone that hate has no home on our campus – hate speech of any kind goes against who we are as an institution and as a diverse community of learners."[2]

3. A few racial incidents occurred between October and December 2017 at Framingham State University in Framingham, MA. In one such incident, a flyer defaced with racially offensive writing was found under an African-American student's door. The President of the University responded: "Framingham State University draws strength from its diversity. We are an institution where individuals of differing cultures, perspectives, and experiences are welcomed, respected, valued and supported. In response to recent events, we must not allow those with hate in their hearts to divide us. The best way to stand up to this type of vile behavior is by uniting as a community against it."[3]
4. Flyers containing a racist slogan and anti-African-American imagery were found at the University of Texas at Austin. The flyers depict a racist caricature of a black man holding a knife and bear the words "Around blacks . . . never relax." The University was quick to condemn such hatred and pointed to their new Hate and Bias Policy that addresses such issues.[4]

A good illustration of a proactive response to incidents of hatred occurred at the University of Hartford in West Hartford, CT. In response to an incident of racial harassment and bullying, Gregory Woodward, president of the University, stated that "the harsh reality is that racism in America is part of our reality. It is here on our campus and on campuses across the country. We are a reflection of the society at large. It is disturbing and inexcusable, and needs our constant attention and vigilance. We must all speak up, speak out, and be relentless in our pursuit of a more inclusive environment for our students. Acts of racism, bias, or other abusive behaviors will not be tolerated in any way, shape, or form on this campus."[5]

Questions

1. Identify which biases and/or stereotypes might exacerbate the type of behavior described in this case.
2. What responsibility does a college or university have in ensuring all students feel safe and welcome at their institutions? Answer this question using Rights Theory and theories of Justice.
3. Why is it important for EDI policies to be implemented in the workplace? Refer to the Deloitte surveys in answering this question.

Case 2-10 WorldCom

The WorldCom fraud was the largest in U.S. history, surpassing even that of Enron. Beginning modestly during mid-year 1999 and continuing at an accelerated pace through May 2002, the company–under the direction of Bernie Ebbers, the CEO; Scott Sullivan, the CFO; David Myers, the controller; and Buford Yates, the director of accounting–"cooked the books" to the tune of about $11 billion of misstated earnings. Investors collectively lost $30 billion as a result of the fraud.

[2]http://www.phillytrib.com/news/racial-epithets-reported-at-cabrini-university/article_6e46de74-2f6c-5813-bae5-cfe0553955ad.html.

[3]https://www.framingham.edu/the-fsu-difference/inclusive-excellence/bias-education-response-team/racism-response.

[4]http://www.statesman.com/news/local/updated-racist-flyers-found-say-around-blacks-never-relax/J0sDeYiBgauXj7oS3pWyUP/.

[5]http://wtnh.com/2017/11/01/pd-university-of-hartford-student-arrested-for-bullying-roommate/.

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The fraud was accomplished primarily in two ways:

1. Booking "line costs" for interconnectivity with other telecommunications companies as capital expenditures rather than operating expenses.
2. Inflating revenues with bogus accounting entries from "corporate unallocated revenue accounts."

During 2002, Cynthia Cooper, the vice president of internal auditing, responded to a tip about improper accounting by having her team do an exhaustive hunt for the improperly recorded line costs that were also known as "prepaid capacity." That name was designed to mask the true nature of the costs and treat them as capitalizable costs rather than as operating expenses. The team worked tirelessly, often at night and secretly, to investigate and reveal $3.8 billion worth of fraud.

Soon thereafter, Cooper notified the company's audit committee and board of directors of the fraud. The initial response was not to take action, but to look for explanations from Sullivan. Over time, Cooper realized that she needed to be persistent and not give in to pressure that Sullivan was putting on her to back off. Cooper even approached KPMG, the auditors that had replaced Arthur Andersen, to support her in the matter. Ultimately, Sullivan was dismissed, Myers resigned, Andersen withdrew its audit opinion for 2001, and the Securities and Exchange Commission (SEC) began an investigation into the fraud on June 26, 2002.

In an interview with David Katz and Julia Homer for *CFO Magazine* on February 1, 2008, Cynthia Cooper was asked about her whistleblower role in the WorldCom fraud. When asked when she first suspected something was amiss, Cooper said: "It was a process. My feelings changed from curiosity to discomfort to suspicion based on some of the accounting entries my team and I had identified, and also on the odd reactions I was getting from some of the finance executives."[1]

Cooper did exactly what is expected of a good auditor. She approached the investigation of line-cost accounting with a healthy dose of skepticism and maintained her integrity throughout, even as Sullivan was trying to bully her into dropping the investigation.

When asked whether there was anything about the culture of WorldCom that contributed to the scandal, Cooper laid blame on Bernie Ebbers for his risk-taking approach that led to loading up the company with $40 billion in debt to fund one acquisition after another. He followed the same reckless strategy with his own investments, taking out loans and using his WorldCom stock as collateral. Cooper believed that Ebbers's personal decisions then affected his business decisions; he ultimately saw his net worth disappear, and he was left owing WorldCom some $400 million for loans approved by the board.

Betty Vinson, the company's former director of corporate reporting, was one of five former WorldCom executives who pleaded guilty to fraud. At the trial of Ebbers, Vinson said she was told to make improper accounting entries because Ebbers did not want to disappoint Wall Street. "I felt like if I didn't make the entries, I wouldn't be working there," Vinson testified. She said that she even drafted a resignation letter in 2000, but ultimately she stayed with the company. It was clear she felt uneasy with the accounting at WorldCom.

Vinson said that she took her concerns to Sullivan, who told her that Ebbers did not want to lower Wall Street expectations. Asked how she chose which accounts to alter, Vinson testified, "I just really pulled some out of the air. I used some spreadsheets."[2]

Her lawyer urged the judge to sentence Vinson to probation, citing the pressure placed on her by Ebbers and Sullivan. "She expressed her concern about what she was being directed to do to upper management, and to Sullivan and Ebbers, who assured her and lulled her into believing that all was well," he said.

[1]David K. Katz and Julia Homer, "WorldCom Whistle-blower Cynthia Cooper," *CFO Magazine,* February 1, 2008. Available at: www.cfo.com/article.cfm/10590507.

[2]Susan Pulliam, "Ordered to Commit Fraud, a Staffer Balked, Then Caved: Accountant Betty Vinson Helped Cook the Books at WorldCom," *The Wall Street Journal,* June 23, 2003. Available at: www.people.tamu.edu/~jstrawser/acct229h/Current%20Readings/E.%20WSJ.com%20-%20A%20Staffer%20Ordered%20to%20Commit%20Fraud,%20Balked.pdf.

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On December 6, 2002 the SEC reached an agreement with Betty Vinson about her role in the WorldCom fraud and suspended her from appearing or practicing before the Commission as an accountant. In its Administrative Proceeding, the SEC alleged that: "At the direction of WorldCom senior management, Vinson and other WorldCom employees caused WorldCom to overstate materially its earnings in contravention of GAAP for at least seven successive fiscal quarters, from as early as October 2000 through April 2002." The overstatement included improperly capitalized line costs to overstate pre-tax earnings by approximately $3.8 billion. The agreement went on to say: "Vinson knew, or was reckless in not knowing, that these entries were made without supporting documentation, were not in conformity with GAAP, were not disclosed to the investing public, and were designed to allow WorldCom to appear to meet Wall Street analysts' quarterly earnings estimates."

Questions

1. Explain the role of cognitive shortcomings in the WorldCom fraud and how social and organizational pressures influenced Betty Vinson's actions.
2. The SEC action against Vinson was deemed "appropriate and in the public interest." How was the public interest affected by what Vinson did and WorldCom's actions broadly?
3. In a presentation at James Madison University in November 2013, Cynthia Cooper said, "You don't have to be a bad person to make bad decisions." Discuss what you think Cooper meant and how it relates to our discussion of ethical and moral development in the chapter.

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Chapter 3

Organizational Ethics and Corporate Governance

Learning Objectives

After studying Chapter 3, you should be able to:

- **LO 3-1** Describe the link between organizational culture, climate, ethical leadership, and ethical decision making.
- **LO 3-2** Explain the link between organizational ethics, individual ethics, and corporate culture.
- **LO 3-3** Describe the signs that an organization has collapsed ethically.
- **LO 3-4** Explain the models of corporate social responsibility.
- **LO 3-5** Discuss the scope and role of corporate governance systems in the ethical decision-making process.
- **LO 3-6** Discuss compliance, integrity, and employee views about ethics in the workplace.
- **LO 3-7** Describe the causes of fraud, detection methods, and preventative controls.
- **LO 3-8** Explain how the provisions of the Sarbanes-Oxley Act relate to corporate governance, including relationships with key parties.
- **LO 3-9** Analyze the moral basis for whistleblowing and accountants' obligations to whistle blow.

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Ethics Reflection

Wells Fargo: The Lessons of an Ethics Failure

On September 8, 2016, Wells Fargo announced it was paying $185 million in fines to Los Angeles city and federal regulators to settle allegations that its employees created millions of fake bank accounts for customers. Top management had set unrealistic sales goals that promoted aggressive sales tactics without regard for the ethics of these policies and what it meant for the public trust.

Wells Fargo engaged in fraud when its employees set up fake accounts for customers, charged them for services not requested, and sold products not wanted because of aggressive cross-selling goals set by the bank. The impact of the Wells Fargo scandal continued well into 2018 as legal settlements with the government were drawn out, class-action lawsuits worked its way through the courts, and whistleblower retaliation lawsuits became resolved. Many questions can be raised as a result of the incident, including why the ethics and compliance machinery at Wells Fargo failed so miserably.[1]

The facts of the case illustrate a company that put 'profits-over-people.'

- 3.5 million of fake bank and credit card accounts opened in customer names. Wells Fargo paid $185 million in fines for the fraud under a national class action lawsuit.
- Improperly charged mortgage fees known as rate-lock extensions when loan approvals exceeded the 30 to 45-day period. These fees were charged even though the delay in approvals were due to the bank, not the customer.
- Set up about 528,000 unauthorized online bill paying services. Wells agreed to pay $910,000 in refunds to customers.
- Forced up to 570,000 borrowers into unneeded auto insurance. The cost of unneeded insurance pushed about 274,000 Wells Fargo customers into delinquency and caused nearly 25,000 wrongful vehicle repossessions. It is estimated the bank will pay $80 million to reimburse customers.
- Additional $5.4 million for illegal vehicle seizures by repossessing more than 860 vehicles of U.S. service members in violation of the Servicemembers Civil Relief Act.

How did Wells Fargo, a bank that once had a strong reputation for customer service, get to this point? It was a failure at all levels of management, but blame was laid at the doorstep of the former CEO, John Stumpf, who was forced to resign. Under his watch, Wells violated just about every standard of ethical behavior, most of which will be addressed in this chapter. For now, here is a list of the systemic failures.

- A failure of leadership.
- Creating a toxic culture.
- Ignoring employee reports of fraudulent accounts.
- Not living up to the standards in its ethics code.
- Retaliating against whistleblowers, including violations of the Sarbanes-Oxley Act.

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The retaliation against Wells Fargo whistleblowers illustrates how a company's own ethics and compliance procedures are no better than the paper they are written on unless top management 'walks the talk' of ethics. Wells had an ethics hotline expressly for the purpose of reporting behavior they suspected as suspicious or fraudulent; then they retaliated against those employees who did just that.[2]

Bill Bado, a former Wells Fargo banker, was one of six former Wells employees who spoke to CNN about their experiences. Bado, who refused orders to open phony bank and credit accounts, called the hotline and sent an email to human resources, flagging unethical sales activities as he had been instructed to do. Eight days after reporting it, Bado was terminated. The reason given was "excessive tardiness."[3]

One unnamed whistleblower, who was a former branch manager in Ponoma, California, received $577,500 in back wages and damages after being fired for reporting co-workers who engaged in allegedly fraudulent activities related to the fake-account scandal by opening accounts and enrolling customers in bank products without their knowledge, consent, or disclosures.

A number of Wells Fargo employees reportedly lodged whistleblower complaints with the Occupational Safety and Health Administration (OSHA) of the U.S. Department of Labor after being fired for reporting ethics violations to the company. The Sarbanes-Oxley Act contains a provision that protects whistleblowers who have been unlawfully retaliated against. One such employee, Claudia Ponce de Leon, was reinstated by OSHA, but the bank is fighting the order, claiming de Leon was fired for inappropriate behavior, not reporting that colleagues were opening fake accounts in order to meet sales goals.[4]

An important device in setting an ethical tone in an organization is to establish a code of ethics and a hotline to report alleged improper activity. Wells Fargo had both but that didn't seem to matter. It's Ethics Policy states:

"Our ethics are the sum of all the decisions each of us makes every day. We have a responsibility to always act with honesty and integrity. When we do so, we earn the trust of our customers. We have to earn that trust every day by behaving ethically, rewarding open, honest communications, and holding ourselves accountable for our decisions and actions."[5]

The saga of Wells Fargo is a company that suffered from ethical blind spots, gave in to situational pressures to meet sales goals at all costs, and functioned in a social and organizational environment that that led employees to do things they otherwise would not have done, i.e., set up fake accounts and charge customers for unwanted services.

Think about the following as you read the chapter: (1) What steps should an organization take to establish an ethical culture? (2) How can corporate governance mechanisms influence ethical decision making? (3) What are the whistleblowing obligations of accounting professionals and their ethical and legal obligations to report financial wrongdoing?

The thing I have learned at IBM is that culture is everything. Underneath all the sophisticated processes, there is always the company's sense of values and identity.

Source: Louis V. Gerstner, Jr., former CEO, IBM

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This statement by former IBM chief executive officer (CEO) Louis Gerstner highlights one of the themes of this chapter: The culture of an organization establishes the boundaries within which ethical decisions must be made. As we learned from previous chapters, it is one thing to know that you should behave in a certain way, but it is quite another to do it (or even want to do it) given the pressures that may exist from within the organization.

What Makes for an Ethical Organization?

LO 3-1

Describe the link between organizational culture, climate, ethical leadership, and ethical decision making.

Organizational ethics can be thought of as the generally accepted principles and standards that guide behavior in business and other organizational contexts. High ethical standards require both organizations and individuals to conform to sound moral principles. In organizations, a critical component of creating an ethical organization environment is the culture that includes shared values, beliefs, goals, norms, and problem solving mechanisms.

Ethical Culture

Corporate culture starts with an explicit statement of values, beliefs, and customs from top management. The statement provides the framework for top management on how to manage themselves and other employees, and how they should conduct their business(es). A code of ethics builds on those values and serves as a guide to support ethical decision making. It clarifies an organization's mission, values, and principles, linking them with standards of professional conduct.

Microsoft is recognized as an ethical company and is a recipient of the designation for 2017 of The World's Most Ethical Companies. Microsoft is one of 124 companies to receive such recognition by *Ethisphere,* an organization that makes the designation based on an Ethics Quotient rating system that includes the following factors: Ethics and Compliance Program; Corporate Citizenship and Responsibility; Culture of Ethics; and Leadership, Innovation, and Reputation. Microsoft has been included in the list for the last seven years.[6]

Microsoft's Standards of Business Conduct define what it stands for: "We are more likely to make ethical choices when integrity, honesty, and compliance guide our decisionmaking." It links building trust with applying the company's culture and values to build lasting relationships inside and outside the company: "Our values are the enduring principles that we use to do business with integrity and win trust every day. Our culture is our operating framework—who we are and how we behave."[7]

An important element of ethical culture is the tone at the top. Tone at the top refers to the ethical environment that is created in the workplace by the organization's leadership. An ethical tone creates the basis for standards of behavior that become part of the code of ethics. Microsoft has established a tone that reflects a commitment to ethical practices.

The tone set by managers influences how employees respond to ethical challenges and is enhanced by ethical leadership. When leaders are perceived as trustworthy, employee trust increases; leaders are seen as ethical and as honoring a higher level of duties. Employees identify with the organization's values and the likely outcome is high individual ethics, high organization ethics, and a lack of dissonance.[8]

If the tone set by management upholds ethics and integrity, employees will be more inclined to uphold those same values. However, if top management appears unconcerned about ethics and focuses solely on

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the bottom line, employees will be more prone to commit fraud, whether occupational (i.e., Wells Fargo's manipulation of customer accounts and services) or participation in fraudulent financial reporting as occurred with Aaron Beam and Betty Vinson.

Ethical Climate

The ethical climate of an organization plays an important role in organizational culture. Whereas an organization's overall culture establishes ideals that guide a wide variety of member behaviors, the ethical climate focuses specifically on issues of right and wrong. We have seen how a toxic climate, such as the one at Wells Fargo, can corrupt virtually all the systems and negate checks and balances designed to ensure ethical standards are followed.

As we discussed in Chapter 2, theories about the world suggest that top management tends to blame individuals for events, rather than their work climate, operational policies and procedures or incentive programs. This often leads to problems being framed inaccurately and can result in unethical decisions, much as occurred at Wells Fargo.

Organizational ethical climate refers to the moral atmosphere of the work environment and the level of ethics practiced within a company. Leaders determine organizational climate, establish character, and define norms. Character plays an important role in leadership. Leaders of good character have integrity, courage, and compassion. They are careful and prudent. Their decisions and actions inspire employees to think and act in a way that enhances the well-being of the organization, its people, and society in general. Ralph Waldo Emerson, the American essayist, poet, and philosopher, said, "Our chief want is someone who will inspire us to be what we know we could be."

Johnson points out that virtues are woven into the inner lives of leaders, shape the way they see and behave, operate independent of the situation, and help leaders to live more fulfilling lives. He identifies courage, temperance, wisdom, justice, optimism, integrity, humility, reverence, and compassion as underlying traits of character of effective leaders. Ethical leaders recognize that moral action is risky but continue to model ethical behavior despite the danger. They refuse to set their values aside to go along with the group, to keep silent when customers may be hurt, or to lie to investors. They strive to create ethical environments even when faced with opposition from their superiors and subordinates. Ethical leaders serve as role models for those within the organization and stakeholders that rely on it.[9]

There is no one size fits all for ethical climates. Johnson believes that an organization must first identify principles and practices that characterize positive ethical climates and then adapt them to a particular organization setting. He identifies key markers of highly ethical organizations including humility, zero tolerance for individual and collective destructive behaviors, justice, integrity, trust, a focus on process, structural reinforcement, and social responsibility. An ethical climate is enhanced through a values-driven organization that encourages openness and transparency and provides a supportive environment to voice matters of concern without fear of retribution or retaliation.[10] An ethical climate should also support policies related to equity, diversity, and inclusion.

Is there a difference between ethical decision making in general, as we discussed in Chapter 2, and ethical decision making in an organizational setting? We believe there are important differences that incorporate both individual and organizational factors into the process. Ferrell et al. describe a process that is depicted in Exhibit 3.1.[11] What follows is a brief explanation of the components of the framework.

Ethical Issue Intensity

Ethical issue intensity reflects the relevance or importance of an event or decision as viewed by the individual, work group, and/or organization. The relative importance of the issue is based on the values, beliefs, and norms involved, as well as situational pressures in the workplace. Ferrell et al. point out that

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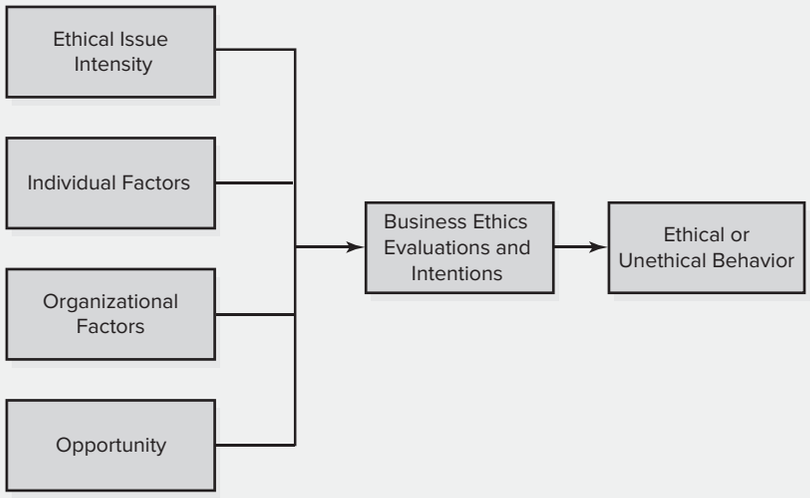
EXHIBIT 3.1 Framework for Understanding Ethical Decision Making in Business



Source: O.C. Ferrell, John Fraedrich, and Linda Ferrell, *Business Ethics: Ethical Decision Making and Cases,* 11th ed. (Stamford, CT: Cengage Learning, 2017, p. 130).

senior employees and those with administrative authority contribute significantly to ethical issue intensity because they typically dictate an organization's position on ethical issues.[12]

Individuals' moral intensity increases their awareness of potential ethical problems for the organization, which in turn reduces their intention to act unethically. However, obedience to authority and pressures of peers can create social and organizational pressures that can lead to cognitive dissonance. At Wells Fargo, many employees adjusted their beliefs to match their behaviors in order to alleviate the dissonance.

Individual Factors

When people need to resolve issues in their daily lives, they often make their decisions based on their own values and principles of right or wrong. Values of individuals can be derived from moral philosophies, such as those discussed in Chapter 1. These provide principles or rules people use to decide what is right or wrong from a moral and personal perspective. Although an individual's intention to engage in ethical behavior relates to individual values, organizational and social forces also play an important role by shaping behavioral intentions and decision making.[13]

Values applied to business can also be used in negative rationalizations, such as "Everyone does it" or "We have to do what it takes to get the business."[14] We learned how Wells Fargo set unrealistic sales goals and pressured employees to go along by rationalizing their behavior as "I'm just following orders."

Organizational Factors

Research has established that in the workplace, the organization's values often have a greater influence on decisions than a person's own values. Ethical decisions in the workplace are made jointly in work groups or other organizational settings. The strength of personal values, the opportunities to behave unethically, and the exposure to others who behave ethically or unethically influence decision making. An alignment between an individual's own values and the values of the organization help create positive work environments and organizational outcomes.[15]

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An important component of organizational culture is the company's ethical culture. Ethical culture reflects the integrity of decisions made and results from corporate policies, top management's leadership on ethical issues, the influence of coworkers, and the opportunity for unethical behavior. Research indicates that ethical values integrated into the organization's culture are positively correlated to employees' commitment to the firm and their sense that they fit into the company.[16] The more employees perceive an organization's culture to be ethical, the less likely they are to make unethical decisions.

Opportunity

Ferrell et al. point out that opportunity describes the conditions in an organization that limit or permit ethical or unethical behavior.[17] Opportunity results from conditions that either provide internal or external rewards or fail to erect barriers against unethical behavior. The opportunities that employees have for unethical behavior in an organization can be reduced or eliminated with aggressive enforcement of rules and codes of ethics.

Opportunity existed at Wells Fargo because of the incentive pay program in effect for tellers and other bank workers. On January 10, 2017, the bank announced its incentive compensation system that was at the root of its fake-accounts scandal would be changed. No longer would sales goals to push workers to open more accounts be the basis for incentive compensation. Instead, the new system would judge employees on how often customers use their accounts and whether customers are satisfied with the bank's services.[18]

Business Ethics Intentions, Behavior, and Evaluations

Ethical dilemmas involve problem-solving situations when the rules governing decisions are often vague or in conflict. The results of an ethical decision are often uncertain; it is not always immediately clear whether or not we made the right decision. Moreover, the decision we make may not always comport with the one we intended to make because of pressures within the organization.

One's intentions influence the final decision but our actions may not match our intentions because of reasons and rationalizations given by superiors to act in a different way. We need a mechanism to evaluate pressures and effectively respond to claims such as everyone does it. Here is where we rely on GVV, which asks the decision maker to identify levers to counteract the pressures and find enablers to support our point of view.

Organizational Influences on Ethical Decision Making

LO 3-2

Explain the link between organizational ethics, individuals ethics, and corporate culture.

Smith and Carroll presented a detailed argument that organizational factors such as socialization processes, environmental influences, and hierarchical relationships collectively constitute a "stacked deck," which impedes moral behavior.[19] Organizational factors are likely to play a role in moral decision making and behavior at two points: establishing moral intent and engaging in moral behavior. Explicit organizational behaviors may cause unethical (or ethical) behavior to result despite good (or bad) intention.

Thomas Jones developed an explanatory model[20] that merged Rest's four-component ethical decision-making model with Fiske and Taylor's work on social cognition to illustrate the ethical decision-making process of an individual who encounters an ethical dilemma within the context of work.[21] Of particular importance is the role that moral intensity plays in recognizing moral issues. Moral issues of high intensity will be more salient because the magnitude of consequences is greater, their effects stand out, and their effects involve significant others (greater social, cultural, psychological, or physical proximity).

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While Jones's model illustrates the impact that moral intensity has on ethical choices and behavior and acknowledges that organizational factors influence the establishment of moral intent and behavior—the last two steps in Rest's model—the model fails to address what Burchard calls the cyclical, ongoing dynamic exchange between the individual and organization, which affects the development and sustaining of one's code of conduct in the organizational context.[22] It was left to Jones and Hiltebeitel to fill the gap when they conducted a study of organizational influence on moral decisions and proposed a model that demonstrated organizational influence on the moral decision-making process.[23] As Jones had done with his previous model, Jones and Hiltebeitel based their model on Rest's moral reasoning and Kohlberg's moral development theory.

The Jones-Hiltebeitel model looks at the role of one's personal code of conduct in ethical behavior within an organization. When an employee was called upon to perform routine tasks—those with no internal conflict or cognitive dissonance—the actions taken were almost automatic. However, when those tasks diverged from the routine, the employee would refer to her personal code of conduct for ethical cues. The implications for ethical behavior within the organization are significant because an unethical individual might act dishonestly in one case, while a virtuous person would act in a truthful, trustworthy manner.

According to the model, when one's personal code is insufficient to make the necessary moral decision, the individual will look at the factors that influenced the formation of the code, including professional and organizational influences to resolve the conflict. The influences that are strongest are the ones that determine the reformation of the individual's code of conduct. The implications for the culture of an organization are significant because an organization that values profits above all else might elicit one kind of response, such as to go along with improper accounting, while an organization that values integrity above all else might lead to questioning improper accounting and doing what one can to reverse false and misleading financial results.[24]

Ethical Dissonance Model

Burchard points out that the Jones-Hiltebeitel model and others like it pay too little attention to the examination of ethical person-organization fit upon the person-organization exchange, within each of the four potential fit options. Burchard presents what she calls the Ethical Dissonance Cycle Model to illustrate the interaction between the individual and the organization, based on the person-organization ethical fit at various stages of the contractual relationship in each potential ethical fit scenario.[25] The model is complex, so we restrict our coverage to the basics of the person-organization interchange and its implications for ethical behavior within organizations. This is an important consideration because the ethics of an individual influences the values that one brings to the workplace and decision making, while the ethics (through its culture) of an organization influences that behavior. To keep it simple, we adopt the idea that there can be a dissonance between what is considered ethical and what may actually be "best" for the subject inviting ethical consideration.

Of the four potential fit options, two possess high person-organization fit: (1) high organizational ethics, high individual ethics (High-High), and (2) low organizational ethics, low individual ethics (Low-Low); and two possess low person-organization fit: (1) high organizational ethics, low individual ethics (High-Low) and (2) low organizational ethics, high individual ethics (Low-High).[26]

Let's pause for a moment and consider the practical implications of this model. Imagine that you are interviewing for a position with a mid-sized company in your town. You can easily find out information about the company on the Internet to prepare for the interview, such as the scope of its operations, products and services, customer base, and geographical locations. However, it is less easy to find out about its reputation for ethics, although reports in the media about specific events might be of some use. Now, let's assume that you knew (and understood) what is meant by organizational fit and in this case the fit is

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Low-High. Would that affect whether you interview with the company? Might you ask questions to better understand why that fit exists? Would it affect your final decision whether to work for the company? The information you might gather during the process could be invaluable when you face ethical dilemmas in the workplace.

In two of the fit options (High-High and Low-Low), no ethical dissonance exists. Person-organization fit is optimal, and the organization is highly effective, either to constructive or destructive ends. The other two (High-Low and Low-High) demonstrate a lack of person-organization fit in the realm of ethics and values.[27]

High Organizational Ethics, High Individual Ethics (High-High)

Assume that you know your values and beliefs are an ethical match for the company you work for. You are likely to continue to stay employed in the organization. The issue for us is how you might assess organizational ethics. Koh and Boo identified three distinct measures of organizational ethics: support for ethical behavior from top management, the ethical climate of the organization, and the connection between career success and ethical behavior.[28] These three factors relate to the culture of the organization and may have implications for actions such as whistleblowing, as discussed later on. Koh and Boo found that positive ethical culture and climate produces favorable organizational outcomes by setting down the ethical philosophy and rules of conduct and practices (i.e., code of ethics).

Low Organizational Ethics, Low Individual Ethics (Low-Low)

When both the individual and organization possess low moral and ethical development, the fit is there, but it is turns in a negative direction. A culture of corruption is difficult to change, and, for the employee, it takes more conscious effort to stop the corruption than to participate in it. You might say that the employee adopts the attitude of going along to get along. Padilla et al. contends that "dysfunctional leader behaviors and susceptible followers interacting in the context of a contributing environment produce negative organizational outcomes in which 'followers must consent to, or be unable to resist, a destructive leader.'"[29]

High Organizational Ethics, Low Individual Ethics (High-Low)

According to Hamilton and Kelman, if the individual possesses lower ethics than that which is held by the organization, the discovery of an individual's lack of person-organization fit is often pointed out by socialized members within the ethical organization.[30] Those assimilated members of the organization may attempt to socialize the individual to the ways of the organization to alleviate the ethical dissonance. Once this dissonance is discovered, the likelihood that the mismatched employee will leave the company rises. The more the individual's personal decisions are seen to be in conflict with the ethical decisions that are perceived to be encouraged by the organization, the greater the discomfort of the individual. Imagine, for example, a newly hired employee thought there was nothing wrong with accepting free gifts from contractors doing business with one's employer, but the employer has a code of ethics forbidding such practices. The culture of the organization conflicts with the individual's low ethical standards in this instance, and others in the organization that identify with organizational values may attempt to resolve the dissonance and alter the employee's behavior. If the employee's behavior does not change, the employee may be let go for cause or insubordination.

Low Organizational Ethics, High Individual Ethics (Low-High)

A reduction in job satisfaction is likely if an employee striving to be ethical perceives little top management support for ethical behavior, an unfavorable ethical climate in the organization, and/or little association between ethical behavior and job success.[31] Once this ethical dissonance is discovered, the likelihood of employee turnover rises. Sims and Keon found a significant relationship between the ethical rift between

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one's personal decisions and the perceived unwritten/informal policies of the organization, and the individual's level of comfort within the organization. The greater the difference between the decisions that the individual made and the decisions perceived as expected and reinforced by the organization, the greater levels of discomfort the individual would feel, and the more likely the individual would be to report these feelings of discomfort.[32] The case of Cynthia Cooper, discussed in Chapter 1, illustrates the low organizational, high individual ethics environment. Cooper reported her concerns to top management, and once she was convinced that nothing would be done to address the improper accounting for capitalized costs, she blew the whistle by going to the audit committee and external auditors.

Seven Signs of Ethical Collapse

LO 3-3

Describe the signs that an organization has collapsed ethically.

We can think of the ethical culture of an organization as a piece of the overall organizational culture. So, if the organizational culture represents "how we do things around here," the ethical culture represents "how we do things around here in relation to ethics and ethical behavior in the organization." The ethical culture represents the organizations "ethics personality." A strong ethical culture is essential in creating an organization that supports people making good ethical decisions and behaving ethically at all times and in all decisions. When all relevant organizational systems are pushing people in the same ethical direction, ethical failure is much less likely.[33]

In her book *The Seven Signs of Ethical Collapse,* Marianne Jennings analyzes the indicators of possible ethical collapse in companies and provides advice how to avoid impending disaster. She starts with a description of ethical collapse, saying that it "occurs when any organization has drifted from the basic principles of right and wrong," and she uses financial reporting standards and accounting rules as one area where this might occur. She points out that "not all companies that have drifted ethically have violated any laws."[34] Enron did not necessarily violate GAAP in treating the effects of *some* of its transactions with special-purpose entities off-balance-sheet. However, the company ignored conflicts of interest of Andy Fastow who managed some of the entities while wearing a second hat as CFO of Enron during the time the two entities had mutual dealings.

According to Jennings, "When an organization collapses ethically, it means that those in the organization have drifted into rationalizations and legalisms, and all for the purpose of getting the results they want and need at almost any cost." A good example is Dennis Kozlowski at Tyco International who misappropriated company resources for personal purposes without the approval of the board of directors and rationalized that he was just doing what those before him had done. Thus, he invoked one of the reasons and rationalizations that we discussed in GVV–Expected or Standard Practice. Jennings links the rationalizations and legalisms to a culture that leads to behavior based on the notion "It's not a question of should we do it." It is a culture of "Can we do it legally?" This mentality occurs because of the combination of the seven factors working together to cloud judgment.[35]

Jennings identifies seven common ethical signs of moral meltdowns in companies that have experienced ethical collapse. The common threads she found that make good people at companies do really dumb things include (1) pressure to maintain numbers; (2) fear and silence; (3) young 'uns and a bigger-than-life CEO (i.e., loyalty to the boss); (4) weak board of directors; (5) conflicts of interest overlooked or unaddressed; (6) innovation like no other company; and (7) goodness in some areas atones for evil in others.[36] We briefly review them next.

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Pressure to Maintain the Numbers

Jennings points out that the tension between ethics and the bottom line will always be present. The first sign of a culture at risk for ethical collapse occurs when there is not just a focus on numbers and results, but an unreasonable and unrealistic obsession with meeting quantitative goals. This "financial results at all costs" approach was a common ethical problem at both Enron and WorldCom. At WorldCom, the mantra was that financial results had to improve in every quarter, and the shifting of operating expenses to capitalized costs was used to accomplish the goal regardless of the propriety of the accounting treatment. It was an "end justifies means" culture that sanctioned wrongdoing in the name of earnings. Accountants like Betty Vinson got caught up in the culture and did not know how to extricate themselves from the situation.

Fear of Reprisals

A culture of fear and silence can easily mask ethical problems. Employees may be reluctant to raise issues of ethical concern because they may be ignored, treated badly, transferred, or worse. Others might rationalize leaving it up to the next employee to report it, or the bystander effect. The whistleblowing process in many organizations does not work as intended because while ethical employees want to blow the whistle, they are reluctant to do so because they fear reprisals, so they stay silent. One aspect of such a culture is a "kill the messenger syndrome," whereby an employee brings bad news to higher-ups with the best intentions of having the organization correct the matter, but instead the messenger is treated as an outcast. The employee finds herself in a situation where her ethics are high but the organization's is low.

Loyalty to the Boss

Dennis Kozlowski, the dominant, larger-then-life CEO of Tyco, had an appetite for a lavish style of living. He surrounded himself with young people who were taken by his stature and would not question his actions. Kozlowski, who once spent $6,000 on shower curtains for an apartment paid for by the company, made sure these "young 'uns" received all the trappings of success so they would be reluctant to speak up when ethical and legal issues existed for fear of losing their expensive homes, boats, and cars and the prestige that comes along with financial success at a young age. Jennings quoted Kozlowski as saying, "I hire them just like me: smart, poor, and want to be rich." Kozlowski selected them for their positions based on their inexperience, possible conflicts of interest, and unlikelihood to question the boss's decisions. Of course, not all bigger-than-life CEOs are unethical (e.g., Warren Buffett).

Weak Board of Directors

A weak board of directors characterizes virtually all the companies with major accounting frauds in the early part of the 2000s. One example is HealthSouth. Richard Scrushy surrounded himself with a weak board so that when he made decisions as CEO that contributed to an accounting scandal where the company's earnings were falsely inflated by $1.4 billion, the board would go along, in part because of their interrelationships with Scrushy and HealthSouth that created conflicts of interest. Jennings identifies the following conflicts of interest:[37]

- One director earned $250,000 per year from a consulting contract with HealthSouth over a seven-year period.
- Another director had a joint investment venture with Scrushy on a $395,000 investment property.
- Another director's company was awarded a $5.6 million contract to install glass at a hospital being built by HealthSouth.
- MedCenter District, a hospital-supply company that was run online, did business with HealthSouth and was owned by Scrushy, six directors, and the wife of one of those directors.

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- The same three directors had served on both the audit committee and the compensation committee for several years.
- Two of the directors had served on the board for 18 years.
- One director received a $425,000 donation to his favorite charity from HealthSouth just prior to his going on the board.

Weak boards can often indicate an organization's ethical collapse, simply because they lack the experience or cohesiveness to challenge an unethical CEO or senior management team.

Culture of Conflicts

A conflict of interest occurs when a person holds a position of trust that requires her to exercise judgment on behalf of others, but where her personal interests and/or obligations conflict with those of others. Andy Fastow was making a lot of money as the general partner of the off-balance-sheet entities that did many deals with Enron. Some at Enron felt the deals were not in its best interests. Still, Fastow was able to convince the Enron board that the entities couldn't exist without his working both sides of the table. Consequently, the board repeatedly gave Fastow a limited waiver of the company's conflict of interest rules in its code of ethics so he could run the off-balance-sheet entities and, simultaneously, serve as Enron's CFO.

Conflicts of interest were pronounced before the passage of the Sarbanes-Oxley Act (SOX) and revision of the New York Stock Exchange corporate governance rules that call for the splitting of the roles of CEO and chair of the board of directors. The problem with having a single person perform dual roles is the CEO is also setting the agenda for the board, thereby creating an inherent conflict because the board is supposed to supervise the CEO. Moreover, it is the board's responsibility to vote on executive compensation packages, so when the CEO is also the chair, she is voting on her own compensation package. Publicly held corporations in the U.S. are required to have a board of directors to oversee top management and ensure top management decisions reflect shareholder interest. In 2010, the SEC under the Dodd-Frank Financial Reform Act adopted rules that required companies to disclose in their proxy statements why the board chair and CEO positions are unified or separated.

Innovations

Too many companies that dissolve in fraud and other wrongdoings felt they were above fray because they were so innovative. In entering a guilty plea to fraud, Sanjay Kumar, former CEO of Computer Associates, remarked: ". . . standard accounting rules [were] not the best way to measure [CA's] results because it had changed to a new business model offering its clients more flexibility."[38] The innovators may come to believe they are immune from the business cycle and almost untouchable. In a sense, they become blind to the ethical issues that arise during and after the innovation process.

Goodness in Some Areas Atones for Evil in Others

Does it make sense that a company steeped in good works for a community and socially responsible behavior should be given a pass if it gets involved in wrongful acts? Many companies rely on their culture of diversity, safety, volunteerism, or environmentally-conscious operations as evidence of their overall ethical goodness, despite improprieties elsewhere as if two "rights" undo a "wrong." Jennings quotes John Rigas, the founder of Adelphia Communications that had a multi-billion dollar fraud in 2002 that included $2.3 billion of co-borrowing between Adelphia subsidiaries and some Rigas family-owned entities: "It's more than money. You've got to give back to the community that supported you." Jennings points out that while he was CEO of Adelphia, John Rigas "gave back" to his daughter and others in business with him.[39]

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Corporate Social Responsibilities

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Explain the models of corporate social responsibility.

It's clear that business has a social responsibility to obey the law. Relationships with employees, customers, suppliers, creditors, etc. create contractual obligations. Legal obligations also exist to avoid negligence, fraud, and other liabilities under tort law. Economists point out that business has a social responsibility to produce the goods and services required for society to function. The philosopher and ethicist, Chris MacDonald, believes the primary question of corporate social responsibilities (CSR) is the extent to which business organizations and their managers have ethical responsibilities that go beyond producing needed goods and services within the law.[40]

For our purposes, when we address issues of CSR, we are referring to the ethical expectations that society has for business. Ethical responsibilities are those things that we ought to, or should, do, even if we prefer not to.[41] A business may not want to develop the systems to remove toxic waste because of cost concerns, but it chooses to do so to garner goodwill through environmentally friendly policies and act in society's interests.

We also address the more obligatory sense of ethical responsibility to prevent harm. A good example is developing (and enforcing) policies against sexual harassment in the workplace. Sexual harassment cases are often fueled by a toxic culture such as the one at the Fox News Channel where it was revealed that Roger Ailes, the former chairman and CEO, had repeatedly harassed one of its hosts, Gretchen Carlson, who turned down Ailes's sexual advances during her eleven-year career at Fox. Her sexual harassment lawsuit was settled for a reported $20 million in 2016. Bill O'Reilly, Fox's top draw, settled a $32 million lawsuit in 2017 just before he signed a new contract. The station knew of the charges by Lis Wiehl, a former Fox News analyst, prior to extending his contract.

The fallout from these high-profile cases led Twenty-First Century Fox, Inc. to issue a statement that it was committed to zero tolerance for sexual harassment, race discrimination, and all other forms of discrimination prohibited by law, and a corporate policy that creates a safe, productive, and welcoming workplace for everyone. Fox claims to have taken steps to address concerns regarding workplace civility and governance. It established the Fox News Workplace Professionalism and Inclusion Council, a committee comprising experts in workplace and inclusion matters, with a majority serving from outside the company.[42]

A few points here. First, there is no doubt that sexual harassment and other forms of discrimination, and we would add cyberbullying in the workplace, do harm to the recipients of these offensive behaviors. Second, the Fox News case illustrates a new corporate commitment to policies of equity, diversity, and inclusion, issues we addressed in Chapter 2. Lastly, in the case of Fox News there seems to have been a climate where top executives turned a blind eye to the toxic culture that pervaded the environment at Fox.

The final way we address CSR issues is whether business has a social responsibility to do good things and make society a better place. Michael Stroik, Manager, Research and Analytics, for the Committee Encouraging Corporate Philanthropy (CECP), spoke about a report issued by CECP that indicates a changing global environment whereby markets are mandating social investments as a price of doing business. The top trends in CSR were found to be: 1) linking a corporation's performance and corporate societal investments, 2) aligning philanthropic efforts with their goals for impact, 3) increasing employee engagement, and 4) increasing non-cash methods of giving.[43]

Socially responsible workplace policies and socially-responsible investments can help with millennial engagement. Millennials are passionate about social causes. According to a 2015 Cone Communications

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Millennial CSR Study, more than 9-in-10 millennials would switch brands to one associated with a cause, and millennials are "prepared to make personal sacrifices to make an impact on issues they care about, whether that's paying more for a product, sharing products rather than buying, or taking a pay cut to work for a responsible company."[44] Socially responsible companies should leverage this commitment to engage in practices that, we might say, illustrate 'Doing Good by Being Good.'

Models of CSR

Economic Model

A business exists to serve the interests of society. This may mean to produce goods and services needed, create jobs, and providing wealth for investors. The economic model of CSR holds that businesses' sole social responsibility is to fulfill the economic functions they were designed to serve. As R. Edward Freemen points out, managers are employees, or agents, of those owners and must work to further the owners' interests. He identifies this perspective as the dominant model of CSR and refers to it as "managerial capitalism."[45]

The economic model of CSR places the shareholders at the center of the corporation and the ethical responsibility of management is to serve those shareholders. Specifically, managers have a primary responsibility to pursue profit within the law. Nobel Prize-winning economist Milton Friedman's classic 1970 *New York Times* article, "The Social Responsibility of Business is to Increase Profits," argues for the economic model.

Some critics contend that Friedman ignored the ethical dimension of business in his statement: "There is one and only one social responsibility of business—to use its resources and engage in activities to increase profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."[46] Friedman certainly recognized the importance of staying within the law. Beyond that, it may seem Friedman's statement implies that decisions that are not driven by fraud or deception are likely to be ethical decisions. Perhaps, but there's more to it than that interpretation. Specifically, we should question whether it's ethical to cut wages in order to maximize profits. There's no deception or fraud, but is it right to harm another to accomplish one's self-interest goals? Is this end justifies the means approach ethical when employees work hard, haven't had a pay raise for five years, and must contend with rising consumer prices?

Did Friedman intend to recognize the moral responsibilities of business and somehow link them to profit-making activities? Hartmann et al. believe so. They state that contrary to popular belief, Friedman does not ignore ethical responsibilities in his analysis but suggested that managers fulfill their ethical responsibility by increasing shareholder wealth and pursuing profit.[47] In other words, so long as shareholder wealth and profitability increase or are benefited by managers' actions, the corporation has met its ethical responsibilities to society. But what happens when laws are passed that impose costs on business and do not increase profits, yet they have an ethical basis to them? Does that mean the company can't meet its ethical responsibilities to shareholders?

A good example is the Sarbanes-Oxley Act (SOX) that was enacted into law on July 30, 2002. Section 404 of the Law imposes significant costs on business to develop internal controls to help prevent and detect wrongful behavior, including fraud, and to minimize the risk that CEOs and CFOs will sign off on financial statements that contain material misstatements. A study by Charles River Associates in 2004 shows that on average, companies in the sample were estimated to have spent $7.8 million each to implement Section 404, including $1.9 million of audit and compliance fees. Some business leaders observed that the costs of compliance exceed the benefits in terms of improved internal control systems over financial reporting and they have urged regulators to modify the implementation rules to reduce the costs associated with Section 404.[48] Of course, determining the benefits is no easy task because how can we know the "savings" by having in place strong controls that cut down on instances of fraud?

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Stakeholder Model

A second perspective on CSR is known as the stakeholder model. The stakeholder model takes a broader view than the shareholder model and recognizes that business exists to create value for a range of parties, including employees, customers, suppliers, and communities as well as investors and stockholders. Business managers have responsibilities to all those who have a stake in the success or failure of the company, not only those who have invested financially.[49]

Freeman's version of stakeholder theory is widely recognized as the most influential. Stakeholder theory begins by recognizing that every business decision affects a wide variety of people, benefiting some and imposing costs on others. Think about the Volkswagen case. The decision makers probably thought the company would benefit by not having to redesign the diesel engines to meet pollution requirements. Most likely they thought profits would be higher as a result. Beyond that, the costs were more significant since customers were cheated, communities were harmed, and, ultimately, shareholder value was lost.[50]

Stakeholder theory recognizes that every business decision imposes costs on someone that must be recognized. A manager who seeks to maximize profits is imposing costs on employees, consumers, and suppliers because the maximization is, typically, driven by price increases or cost reductions. The dominant economic model argues that these costs are justified because management owes an ethical duty to shareholders. The stakeholder model acknowledges this but argues that other ethical duties have an equal claim on managerial decision making.[51]

Examples of CSR

The Case of the Ford Pinto

The case of the Ford Pinto illustrates a classic example of how a company can make a fatal mistake in its decision making by failing to consider the interests of the stakeholders adequately. The failure was due to total reliance on utilitarian thinking instead of the universality perspective of rights theory, to the detriment of the driving public and society in general.

The Pinto was Ford Motor Company's first domestic North American subcompact automobile, marketed beginning on September 11, 1970. It competed with the AMC Gremlin and Chevrolet Vega, along with imports from makes such as Volkswagen, Datsun, and Toyota. The Pinto was popular in sales, with 100,000 units delivered by January 1971, and was also offered as a wagon and Runabout hatchback. Its reputation suffered over time, however, especially from a controversy surrounding the safety of its gas tank.

The public was shocked to find out that if the Pinto cars experienced an impact at speeds of only 30 miles per hour or less, they might become engulfed in flames, and passengers could be burned or even die. Ford faced an ethical dilemma: what to do about the apparently unsafe gas tanks that seemed to be the cause of these incidents. At the time, the gas tanks were routinely placed behind the license plate, so a rear-end collision was more likely to cause an explosion (whereas today's gas tanks are placed on the side of the vehicle). However, the federal safety standards at the time did not address this issue, so Ford was in compliance with the law. Ford's initial response was based on ethical legalism—the company complied with all the laws and safety problems, so it was under no obligation to take any action.

Eventually, Ford did use ethical analysis to develop a response. It used a risk–benefit analysis to aid decision making. This was done because the National Highway Traffic Safety Administration (NHTSA) excused a defendant from being penalized if the monetary costs of making a production change were greater than the "societal benefit" of that change. The analysis followed the same approach modeled after Judge Learned Hand's ruling in *United States v. Carroll Towing* in 1947 that boiled the theory of negligence down to the following: If the expected harm exceeded the cost to prevent it, the defendant was obligated to take the precaution, and if he (or it, in the case of a company) did not, liability would result. But if the cost

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was larger than the expected harm, the defendant was not expected to take the precaution. If there was an accident, the defendant would not be found guilty.[52] A summary of the Ford analysis follows.

Ford's Risk-Benefit Analysis[53]

Benefits of Fixing the Pintos

Savings: 180 burn deaths, 180 serious burn injuries, 2,100 burned vehicles

Unit cost: $200,000 per death (figure provided by the government); $67,000 per burn injury and $700 to repair a burned vehicle (company estimates)

Total benefits: 180 × ($200,000) + 180 × ($67,000) + 2,100 × ($700) = **$49.5 million**

Costs of Fixing the Pintos

Sales: 11 million cars, 1.5 million light trucks

Unit cost: $11 per car, $11 per light truck

Total cost: 11,000,000 × ($11) + 1,500,000 × ($11) = **$137 million**

Based on this analysis and other considerations, including not being required by law to change its product design, Ford decided not to change the placement of the fuel tank.

Ford's risk–benefit analysis relied only on act-utilitarian reasoning, an approach that ignores the rights of various stakeholders. A rule-utilitarian approach might have led Ford to follow the rule "Never sacrifice public safety." A rights theory approach would have led to the same conclusion, based on the reasoning that the driving public has an ethical right to expect that their cars will not blow up if there is a crash at low speeds.

Ethical decision making is more difficult when an important factor is omitted from the analysis, which can happen if a cognitive error occurs. The framing of the problem may be inadequate to the task and make it more difficult to properly define the scope of the problem. For example, Ford did not include as a potential cost the lawsuit judgments that might be awarded to the plaintiffs and against the company. For example, in May 1972, Lily Gray was traveling with 13-year-old Richard Grimshaw when their Pinto was struck by another car traveling approximately 30 miles per hour. The impact ignited a fire in the Pinto, which killed Gray and left Grimshaw with devastating injuries. A judgment was rendered against Ford, and the jury awarded the Gray family $560,000 and Matthew Grimshaw, the father of Richard Grimshaw, $2.5 million in compensatory damages. The surprise came when the jury also awarded $125 million in punitive damages. This was subsequently reduced to $3.5 million.[54]

In the aftermath of the scandal, it is interesting to consider whether any of the Ford executives who were involved in the decision-making process would have predicted in advance that they would have made such an unethical choice. Dennis Gioia, who was in charge of recalling defective automobiles at Ford, did not advocate ordering a recall. Gioia eventually came to view his decision not to recall the Pinto as a moral failure—what De Cremer and Tenbrunsel call a failure to think outside his prevailing background narrative or script at the point of decision. "My own schematized (scripted) knowledge influenced me to perceive recall issues in terms of the prevailing decision environment and to unconsciously overlook key features of the Pinto case . . . mainly because they did not fit an existing script." While personal morality was very important to Gioia, he admits that the framing narrative of his workplace "did not include ethical dimension."[55] The moral mistake was that there were other, better choices that he could have made—albeit ones outside the purview of Gioia's framing narrative.

Lessons Learned?

Has the automobile industry learned a lesson from Ford's experience with the Pinto? The answer is an unequivocal no. We've learned about the VW defeat device case, and here is another example of moral blindness by a supplier of parts to an automobile company.

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On September 1, 2017, Honda agreed to a $605 million so-called economic loss settlement covering up to 16.5 million U.S. vehicles with potentially faulty Takata air bag inflators. The settlement covers damages linked to inflators, including claims that vehicles were inaccurately represented to be safe, and that buyers had overpaid for cars with defective or substandard air bags. At least 18 deaths and 180 injuries worldwide have been tied to the defect that led to Takata filing for bankruptcy protection. At the time of this writing, 19 automakers had recalled more than 42 million vehicles in the largest auto safety callback in history. Takata expects 125 million vehicles worldwide will eventually be recalled due to its defect-prone inflators.[56] Various reports indicate that Honda and Takata knew about the faulty inflators since 2004 but failed to notify the National Highway Traffic Safety Administration in previous recalls (which began in 2008) that the affected airbags actually ruptured or were linked to injuries or deaths.

Johnson & Johnson

It's not easy finding a company that did the right thing when faced with an ethical dilemma about the safety of a product sold to the public. Even though it occurred more than thirty-five years ago, Johnson & Johnson's experience with poisoned Tylenol capsules stands as an example of how at least one company properly framed the ethical issues and made decisions to protect the public rather than take advantage of it.

Johnson & Johnson faced a crisis in the fall of 1982, when seven people in the Chicago area collapsed suddenly and died after taking Tylenol capsules that had been laced with cyanide. These five women and two men became the first victims ever to die from what came to be known as "product tampering." The news of this incident traveled quickly and was the cause of a massive, nationwide panic.

Johnson & Johnson reacted swiftly to the news and by all accounts the company took the steps necessary to gain the public trust. Many wondered why Johnson & Johnson was able to do what other companies like Ford could not. The company pointed to their corporate credo that detailed the ethical values of the company. The credo appears in Exhibit 3.2.

EXHIBIT 3.2 Johnson & Johnson Credo

We believe our first responsibility is to the doctors, nurses, and patients, to mothers and fathers and all others who use our products and services. In meeting their needs, everything we do must be of high quality. We must constantly strive to reduce our costs in order to maintain reasonable prices. Customers' orders must be serviced promptly and accurately. Our suppliers and distributors must have an opportunity to make a fair profit.

We are responsible to our employees, the men and women who work with us throughout the world. Everyone must be considered as an individual. We must respect their dignity and recognize their merit. They must have a sense of security in their jobs. Compensation must be fair and adequate, and working conditions clean, orderly, and safe. We must be mindful of ways to help our employees fulfill their family responsibilities. Employees must feel free to make suggestions and complaints. There must be equal opportunity for employment, development, and advancement for those qualified. We must provide competent management, and their actions must be just and ethical.

We are responsible to the communities in which we live and work, and to the world community as well. We must be good citizens—support good works and charities and bear our fair share of taxes. We must encourage civic improvements and better health and education. We must maintain in good order the property we are privileged to use, protecting the environment and natural resources.

Our final responsibility is to our stockholders. Business must make a sound profit. We must experiment with new ideas. Research must be carried on, innovative programs developed, and mistakes paid for. New equipment must be purchased, new facilities provided, and new products launched. Reserves must be created to provide for adverse times. When we operate according to these principles, the stockholders should realize a fair return.

Source: Johnson & Johnson Credo, http://www.jnj.com/sites/default/files/pdf/jnj_ourcredo_english_us_8.5x11_cmyk.pdf.

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Unlike a code of ethics that details expectations for behavior and consequences for failure, a credo is an aspirational statement of what the company values. The Johnson & Johnson credo clearly sets a positive tone. Notice how it emphasizes the company's primary obligations to those who use and rely on the safety of its products. The credo focuses on rights and obligations—to the health care community, patients and employees—and it implies that shareholders will earn a fair return if the company operates in accordance with its ethical values. Johnson & Johnson was credited with being an ethical organization in part because of the way it handled the Tylenol poisoning incidents in 1982 and its experience is discussed in most business ethics textbooks.

Tamara Kaplan, a professor at Penn State University, contends that Johnson & Johnson used the Tylenol poisonings to launch a public relations program immediately to preserve the integrity of both their product and their corporation as a whole. We find this to be a vacuous position, however. By Kaplan's own admission, "Johnson & Johnson's top management put customer safety first, before they worried about their company's profit and other financial concerns."[57] This hardly sounds like a company that used a catastrophic event to boost its image in the eyes of the public.

Johnson & Johnson's stock price dropped precipitously after the initial incident was made public. In the end, the stock price recovered because the company's actions gained the support and confidence of the public. Johnson & Johnson acted swiftly to remove all the product from the shelves of supermarkets, provide free replacements of Tylenol capsules with the tablet form of the product, and make public statements of assurance that the company would not sell an unsafe product. To claim that the company was motivated by a public relations agenda (even though in the end, its actions did provide a public relations boon for the company) is to ignore a basic point that Johnson & Johnson's management may have known all along: that is, good ethics is good business. We wish this story had a happier ending. Unfortunately, Johnson & Johnson has been involved in several incidents of unsafe products and has absorbed billions in lawsuits from the public during the past ten years.

The Wharton School looks at some of the product recalls and concludes the company had quality control problems with several of its brands. For example, the painkiller Motrin was found to be dissolving improperly and two hip replacement devices that were recalled in 2010 after the shredding of metal fragments led to post-surgical complications in some patients. The company also agreed to pay the state of Texas $158 million to settle claims it improperly marketed the anti-psychotic drug Risperdal to patients on Medicaid. Ironically, the article questions whether Johnson & Johnson was putting profits over patient safety. A marketing professor offered that it was a failure in the quality of management at all levels and says the company has to be more responsive than ever to potential problems.[58] No doubt, letting problems fester makes them worse and invites the slippery slope into ethical decision making.

Trust in Business

"Responsibility creates trust" is the credo of Bosch, the German multinational engineering and electronics company. Trust in business is the cornerstone of relationships with customers, suppliers, employees, and others who have dealings with an organization. Trust means to be reliable and carry through words with deeds. Trust becomes pervasive only if the organization's values are followed and supported by top management. By modeling the organization's values, senior leaders provide a benchmark for all employees.

A good example of building trust in an organization is from Paul O'Neill, former CEO at Alcoa Inc., the world's third-largest producer of aluminum. O'Neill created a reputation for trust among his employees by setting strict ethical standards and carrying through with them. In an interview with "PBS Newshour" on July 9, 2002, O'Neill was asked by reporter Jim Lehrer why Alcoa was able to avoid the accounting scandals that infected so many companies in the late 1990s and early 2000s. He responded with the following

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statement: "When I went there [to Alcoa], I called the chief financial officer and the controller and I said to them, 'I don't want to ever be accused of or guilty of managing earnings,' that is to say making earnings that really aren't as a consequence of operations." O'Neill went on to express in the interview his dismay at the number of cases where employees of a company were told that here are our company's values, and then senior management totally ignored those same values.

Trust can be lost, even if once gained in the eyes of the public, if an organization no longer follows the guiding principles that helped to create its reputation for trust. The long list of product defects at Johnson & Johnson proves that point.

Foundations of Corporate Governance Systems

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Discuss the scope and role of corporate governance systems in the ethical decision-making process.

In his book *Corporate Governance and Ethics,* Zabihollah Rezaee points out that corporate governance is shaped by internal and external mechanisms, as well as policy interventions through regulations. Internal mechanisms help manage, direct, and monitor corporate governance activities to create sustainable stakeholder value. Examples include the board of directors, particularly independent directors; the audit committee; management; internal controls; and the internal audit function. External mechanisms are intended to monitor the company's activities, affairs, and performance to ensure that the interests of insiders (management, directors, and officers) are aligned with the interests of outsiders (shareholders and other stakeholders). Examples of external mechanisms include the financial markets, state and federal statutes, SEC regulations, court decisions, and shareholder proposals.[59] Three noteworthy points are: (1) independent directors enhance governance accountability; (2) separation of the duties of the CEO and board chair minimizes conflicts of interest; and (3) separate meetings between the audit committee and external auditors strengthen control mechanisms.

Ethical and Legal Responsibilities of Officers and Directors

Duty of Care—Managers and Directors

Directors and officers are deemed fiduciaries of the corporation because their relationship with the corporation and its shareholders is one of trust and confidence. As fiduciaries, directors and officers owe ethical–and legal–duties to the corporation and to the shareholders. These fiduciary duties include the duty of care and the duty of loyalty.

The standard of *due care* provides that a director or officer act in good faith, exercise the care that an ordinarily prudent person would exercise in similar circumstances, and act in the way that she considers to be in the best interests of the corporation. Directors and officers who have not exercised the required duty of care can be held liable for the harms suffered by the corporation as a result of their negligence. Notice how this standard ties into Kant's Categorical Imperative: Act only according to that maxim whereby you can, at the same time, will that it should become a *universal law.* The universal standard is one of due care.

The duty of care also involves the exercise of reasonable care by a board member to ensure that the corporate executives with whom she works carry out their management responsibilities and comply with the law in the best interests of the corporation.[60]

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Duty of Loyalty

The *duty of loyalty* requires faithfulness; a director must place the interests of the corporation ahead of personal interests. For example, directors must not use corporate funds or confidential corporate information for personal advantage. A conflict occurs when a board member hears of a potential deal that might affect the selling price of company stock (up or down). The board member's attempt to profit from this knowledge is called insider trading; it's illegal as well as being a conflict of interest.[61] Another conflict would be if a board member is involved in a personal relationship with an employee of the company. The employee's position with the company might be affected by the relationship and allegations of sexual harassment could harm corporate interests.

Duty of Good Faith

The obligation of *good faith* requires an honesty of purpose that leads to caring for the well-being of the constituents of the fiduciary. Vice Chancellor Leo Strine of the Delaware Chancery Court linked good faith to fiduciary analysis in the Enron fraud by suggesting that the Enron case might influence courts to look more carefully at whether directors have made a good faith effort to accomplish their duties. He connected good faith with directors' "state of mind." Strine identified certain kinds of director conduct that may call good faith into question. These include "a failure to monitor if [the directors'] laxity in oversight was so persistent and substantial that it evidences bad faith." It can also arise in situations where "committee members knew that their inadequate knowledge disabled them from discharging their responsibilities with fidelity."[62]

Business Judgment Rule

A corporate director or officer may be able to avoid liability to the corporation or to its shareholders for poor business judgments under the *business judgment rule.* Directors and officers are expected to exercise due care and to use their best judgment in guiding corporate management, but they are not insurers of business success. Honest mistakes of judgment and poor business decisions on their part do not make them liable to the corporation for resulting damages.

To obtain the business judgment rule's protection, directors must be independent and disinterested as to the matter acted upon. Directors must act with due care and good faith. The due care inquiry is process-oriented, and due care is measured by a standard of gross negligence (i.e., reckless behavior), not simple negligence. The burden of proof is on the party challenging the board's decision, to establish facts rebutting the presumption in favor of upholding the decision. Unless a plaintiff succeeds in rebutting the rule, the court will not substitute its views for those of the board's if the latter's decision can be "attributed to any rational business purpose."

The business judgment rule generally immunizes directors and officers from liability for the consequences of a decision that is within managerial authority, as long as the decision complies with management's fiduciary duties and as long as acting on the decision is within the powers of the corporation. Therefore, if there is a reasonable basis for a business decision, it is unlikely that a court will interfere with that decision, even if the corporation suffers as a result.

Chancery Court

The Chancery Court located in Delaware is the preeminent forum for the resolution of commercial business litigation matters including the duties of officers and directors. The Court's fundamental purpose is to be an equity court–to provide relief suited to the circumstances when no adequate remedy is available at law.

The broad interpretation of the business judgment rule was on display on August 9, 2005, when Chancellor William B. Chandler III of the Delaware Court ruled that the directors of the Walt Disney Company acted

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in good faith when Michael Ovitz was hired in 1995 to be the CEO of Disney and then allowed to walk away 15 months later with a severance package valued at $130 million after being fired by Michael Eisner, the chair of the board of directors. In a lawsuit challenging the board's action, the shareholder plaintiffs alleged that the Disney's directors had breached their fiduciary duties both in approving Ovitz's employment agreement and in later allowing the payment of the non-fault termination benefits. The Delaware Supreme Court affirmed the Court of Chancery's conclusion that the shareholder plaintiffs had failed to prove that the defendants had breached any fiduciary duty of care. As to the ensuing no-fault termination of Ovitz and the resulting termination payment pursuant to his employment agreement, the Supreme Court affirmed the trial court's holdings that the full board did not (and was not required to) approve Ovitz's termination, that Michael Eisner had authorized the termination, and that neither Eisner, nor Sanford Litvack, Disney's General Counsel, had breached his duty of care or acted in bad faith in connection with the termination.[63]

Components of Corporate Governance Systems

An essential part of creating an ethical organization environment is to put in place effective corporate governance systems that establish control mechanisms to ensure that organizational values guide decision making and that ethical standards are being followed. Corporate governance entails developing formal systems of accountability, oversight, and control. Strong corporate governance mechanisms lessen the opportunity for employees to make unethical decisions. Research has shown that corporate governance has a positive relationship with social responsibility. Moreover, firms with strong corporate governance mechanisms that call for the disclosure of social responsibility initiatives can establish legitimacy and trust among their stakeholders.[64]

There are many ways to define corporate governance. We prefer the definition by Ferrell et al.[65] described below.

> Accountability refers to how closely workplace decisions align with a firm's strategic direction and its compliance with ethical and legal considerations. Oversight provides a system of checks and balances that limit employees' and managers' opportunities to deviate from policies and strategies aimed at preventing unethical and illegal activities. Control is the process of auditing and improving organizational decisions and actions.

Models of Corporate Governance

Differences exist about the role of corporate governance in business. Some organizations take the view that as long as they are maximizing shareholder wealth and profitability, they are fulfilling their core responsibilities. Other firms take a broader view based on the stakeholder perspective.

The shareholder model of corporate governance is founded on classic economic precepts, including maximizing wealth for investors and creditors. In a public corporation, firm decisions should be oriented toward serving the best interests of investors. Underlying these decisions is a classic agency problem, in which ownership (investors) and control (managers) are separate. Managers act as the agents of the investors (principals), who expect those decisions to increase the value of the stock they own.[66] However, managers may have motivations beyond stockholder value such as increasing market share or more personal ones including maximizing executive compensation. In these instances, decisions may be based on an egoist approach to ethical decision making that ignores the interests of others. An enlightened egoist approach is more in keeping with capitalistic theory whereby other interests are considered by managers prior to deciding how best to serve their own interests. For example, it could be that managers believe an increase in the corporate dividend serves their interest because it may convince shareholders that managers are acting like responsible agents.

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Albrecht et al. point out that the principal-agent relationship involves a transfer of trust and duty to the agent, while also assuming that the agent is opportunistic and will pursue interests that are in conflict with those of the principal, thereby creating an "agency problem."[67] Because of these potential differences, corporate governance mechanisms are needed to align investor and management interests. A fundamental challenge underlying all corporate governance affairs dates back to the days of Adam Smith. In *The Wealth of Nations,* Smith said that "the directors of companies, being managers of other people's money, cannot be expected to watch over it with the same vigilance with which they watch over their own."

One traditional approach is for shareholders to give the CEO shares or options of stock that vest over time, thus inducing long-term behavior and deterring short-term actions that can harm future company value. When the interests of top management are brought in line with interests of shareholders, agency theory argues that management will fulfill its duty to shareholders, not so much out of any sense of moral duty to shareholders, but because doing what shareholders have provided incentives for maximizes their own utility.[68]

Jensen and Meckling demonstrate how investors in publicly traded corporations incur (agency) costs in monitoring managerial performance. In general, agency costs arise whenever there is an "information asymmetry" between the corporation and outsiders because insiders (the corporation) know more about a company and its future prospects than do outsiders (investors).[69]

Agency costs can occur if the board of directors fails to exercise due care in its oversight role of management. Enron's board of directors did not monitor the company's incentive compensation plans properly, thereby allowing top executives to "hype" the company's stock so that employees would add it to their 401(k) retirement plans. While the hyping occurred, often through positive statements about the company made by CEO Ken Lay, Lay himself sold about 2.3 million shares for $123.4 million.

The agency problem can never be perfectly solved, and shareholders may experience a loss of wealth due to divergent behavior of managers. Investigations by the SEC and U.S. Department of Justice of 20 corporate frauds during the Enron-WorldCom era indicate that $236 billion in shareholder value was lost between the time the public first learned of the first fraud and September 3, 2002, the measurement date.

An alternative to agency theory is stewardship theory. In this theory, managers and directors are viewed as stewards of their companies and have a fiduciary duty to act in the best interests of the shareholders. The theory holds that as stewards, managers and directors will choose the interests of shareholders, perhaps psychologically identified as the best interests of "the company," over self-interests, regardless of personal motivations or incentives.[70] Contrary to agency theory, stewardship theory believes that directors do not inevitably act in a way that maximizes their own personal interests: They can and do act responsibly with independence and integrity. Even though some will fail, it does not invalidate the theory.[71]

Stewardship advocates recognize that directors need to consider a broader range of interests, including employees, customers, suppliers, and other legitimate stakeholders, but under the law their first responsibility is to the shareholders. They argue that conflicts of interest between stakeholder groups and the company should be met by competitive pressures in free markets, backed by legislation and legal controls to protect various stakeholder interests (i.e., environmental law; health and safety law; employment discrimination law).

Executive Compensation

One of the most common approaches to the agency problem is to link managerial compensation to the financial performance of the corporation in general and the performance of the company's shares. Typically, this occurs by creating long-term compensation packages and stock option plans that tie executive wealth to an increase in the corporation's stock price. These incentives aim to encourage managers to

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maximize the market value of shares. One of the biggest issues that corporate boards of directors face is executive compensation. It has been found that most boards spend more time deciding how much to compensate top executives than they do ensuring the integrity of the company's financial reporting systems.[72]

Executive Pay Packages

A problem arises when top management purposefully manipulates earnings amounts to drive up the price of stock so they can cash in more lucrative stock options. During the financial crisis of 2008–2009, Congress charged executives at some of the nation's largest companies with gaining pay packages in the millions while their companies suffered losses, and they may have even accepted funds from the government to keep them liquid. The Obama administration named a "compensation czar," Kenneth Feinberg, to set salaries and bonuses at some of the biggest firms at the heart of the economic crisis, as part of a broader government campaign to reshape pay practices across corporate America. The initiative reflected public uproar over executive compensation at companies such as American International Group (AIG), which received a $180 billion bailout from the government and decided to pay $165 million in bonuses to executives.

A 2016 study by the Economic Policy Institute in the U.S. indicates that the CEOs at one of the largest 350 companies made an average of $15.6 million in compensation, or 271 times the annual average pay of the typical worker. The ratio was 20-to-1 in 1965.[73] On a global basis, based on 2014 figures, this compares with a ratio of 148:1 in Switzerland, the nearest country, 84:1 in the United Kingdom, and 67:1 in Japan.[74]

Similar to the Disney example, a troubling situation occurred when the former CEO of CVS received a severance package worth $185 million when he left in early 2011, even though the company's net earnings had declined in the prior year. In 2014, the former chief operating officer of Yahoo, who was fired earlier in the year, received about $96 million in compensation for his 15 months on the job, including about $58 million in severance packages.

The disparity between average worker and CEO pay raises issues of equity. Thomas Dunfee, a Wharton professor of legal studies and business ethics, puts it this way: Do executive compensation figures reflect an efficient market, or a failed one? Are pay levels adequately disclosed? Should shareholders have more say? Are there issues of fairness and justice?[75]

Backdating Stock Options

An executive compensation scandal erupted in 2006 when it was discovered that some companies had changed the grant dates of their options to coincide with a dip in the stock price, making the options worth more because less money would be needed to exercise them and buy stock. Although backdating was legal, it must be expensed and disclosed properly in the financial statements. Legalities aside, it is difficult to justify such a practice from an ethical perspective because it purposefully manipulates the option criteria that determine their value.

In the wake of this scandal, hundreds of companies conducted internal probes and the SEC launched investigations into more than 140 firms. The agency filed charges against 24 companies and 66 individuals for backdating-related offenses, and at least 15 people have been convicted of criminal conduct. An interesting case is that of Nancy Heinen, Apple Computer's general counsel until she left in 2006. She was investigated by the SEC for receiving backdated options and wound up agreeing to pay $2.2 million in disgorgement (return of ill-gotten gains), interest, and penalties. Steve Jobs, the former CEO of Apple, apologized on behalf of the company, stating that he did not understand the relevant accounting laws. Of course, ignorance of the law is no excuse for violating it, especially by someone like Jobs, who presumably had dozens of accountants on staff to advise on these matters. Notably, the Sarbanes-Oxley Act includes stricter reporting requirements that are supposed to cut down on such practices.

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Clawbacks

The Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173)[76] was signed into federal law by President Barack Obama on July 21, 2010. Passed as a response to the late-2000s recession, it brought the most significant changes to financial regulation in the U.S. since the regulatory reform that followed the Great Depression. Two areas where Dodd-Frank relates to corporate governance are in executive compensation and in whistleblowing procedures, which will be discussed later on.

Clawbacks have been on the regulatory radar screen in a big way since 2002, when SOX gave the SEC power to recover compensation and stock profits from CEOs and CFOs of public companies in the event of financial restatements caused by misconduct. Clawback policies among Fortune 100 companies were already on the rise before the financial crisis, jumping from 17.6% in 2006 to 42.1% in 2007. In 2010, the year Dodd-Frank was passed, 82.1% of the Fortune 100 had them. In 2012, 86.5% of the Fortune 100 firms had adopted publicly disclosed policies. Now, about 90% have such policies. The ethical justification for clawbacks is the breach of fiduciary duty owed by top management to shareholders and inequities when they benefit from their own wrongful acts.

On July 1, 2015, the SEC proposed rules directing U.S. stock exchanges to create listing standards requiring listed companies to implement policies to recover or "claw back" incentive-based compensation received by executive officers as a result of materially incorrect financial statements. These proposed rules are mandated by Section 954 of Dodd-Frank. Because the SEC has not finalized its Clawback Policy Rules, it is unlikely that companies will be required to adopt the proposed clawback policies in 2017 or even soon thereafter.

According to a PwC study, many companies have modified their clawback policies since enactment of SOX and Dodd-Frank, and others have indicated that their policies will likely change once the SEC issues its clawback rules. Of the 100 companies in the study, 90% have policies to recover compensation if there is a restatement of financial results. However, of those that claw back upon restatement, 73% require evidence that the employee caused or contributed to false or incorrect financial reporting, while 27% require repayment in the event of a restatement even without any personal accountability. Another prevalent reason for clawbacks was misconduct (83%), which includes breaking a companies code of conduct or ethics policies.[77]

The scandal at Wells Fargo led to millions in clawbacks of executive compensation. Carrie Tolstedt, former head of the bank's retail division, had a $67 million clawback; John Stumpf, $69 million; and an additional $44 million from three other executives, for a total of $180 million. This is the largest clawback ever for a financial services firm.

Say on Pay

Dodd-Frank includes "say-on-pay" provisions (Section 951) that require SEC-registered issuers to provide shareholders at least once every three calendar years a separate nonbinding say-on-pay vote regarding the compensation of the company's named executive officers (i.e., CEO and CFO) and the company's three other most highly compensated officers. Although the vote on compensation is nonbinding, the company must include a statement in the "Compensation Discussion and Analysis" of the proxy statement whether its compensation policies and decisions have taken into account the results of the shareholder-say-on-pay vote and, if so, how. The idea is for the vote of the shareholders to be taken seriously not only by the company, but also by other companies in the same marketplace.

In perhaps the most widely followed shareholder action, in April 2012, 55% of Citigroup's shareholders voted against CEO Vikram Pandit's $15 million compensation package for 2011, a year when the bank's stock tumbled. At the time of the vote, Pandit had received nearly $7 million in cash for 2011, with the remainder to be paid in restricted stock and cash over the next few years (and thus subject to possible

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restructuring by the board). Citigroup's shareholders expressed concerns that the compensation package lacked significant and important goals to provide incentives for improvement in the shareholder value of the institution. Soon after the vote, a shareholder filed a derivative lawsuit against the CEO, the board of directors, and other directors and executives for allegedly awarding excessive pay to its senior officers.

On April 29, 2015, the SEC proposed new rules requiring public companies to make it easier for investors to judge whether top executives' compensation is in step with the company's financial performance. The proposal aims to give investors greater clarity about the link between what corporate executives are paid each year and total shareholder return—the annual change in stock price plus reinvested dividends. If finalized, companies would have to include a new table in their annual proxy filings disclosing top executives' "actual pay." The new figure is based on the total compensation public companies already calculate for their five highest-paid executives, though it would exclude certain components of pay that officers do not actually take home, such as share grants that have yet to vest.

Questions raised by shareholders and others about the size of executive compensation packages and say-on-pay votes are designed to build equity into the compensation system. Issues with respect to whether CEOs are overpaid, as many have said, do bring up questions of fairness and justice. Without transparency, it is difficult to have accountability. Over the long haul, the question is whether these nonbinding referendums are likely to have any impact on the potential civil liability of directors for approving allegedly excessive executive compensation that the shareholders reject. According to Robert Scully, who analyzed the law in the January 2011 *The Federal Lawyer,* the answer is probably not. Scully maintains that Dodd-Frank does not preempt state fiduciary law or entirely occupy the field of director liability for excessive compensation. Instead, the act focuses on the process by which public company executive compensation is set, thereby enforcing the primacy of the business judgment rule in determining executive compensation.[78]

Corporate Governance Oversight and Regulation

Following the large number of frauds and business failures in the later 1990s and early 2000s, regulators turned to the systems in place to monitor corporate behavior. This led to developing policies and procedures to strengthen the oversight and regulation of corporate governance mechanisms, in particular the board of directors and audit committee. Prior to the passage of SOX in the U.S., the United Kingdom had dealt with this problem and established the Cadbury Committee.

The Committee on the Financial Aspects of Corporate Governance, (Cadbury Committee), was established in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession. The motivation for the Committee's creation was an increasing lack of investor confidence in the honesty and accountability of listed companies, following a large number of bank failures in the early 1990s including the collapse of the Bank of Credit and Commerce International and exposure of its widespread criminal practices.

The essence of Cadbury recommendations was to develop an approach 'based on compliance with a voluntary code coupled with disclosure, that would prove more effective than a statutory code'. The central components of this voluntary code, the Cadbury Code, are:[79]

- that there be a clear division of responsibilities at the top, primarily that the position of Chairman of the Board be separated from that of Chief Executive, or that there be a strong independent element on the board;
- that the majority of the Board be comprised of outside directors;
- that remuneration committees for Board members be made up in the majority of non-executive directors;
- that the Board should appoint an Audit Committee including at least three non-executive directors.

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An outside or non-executive director is a member of a company's board of directors who is not part of the executive team. Non-executive directors, also known as external directors, independent directors, or outside directors, do not hold executive level or managerial positions. These directors are thought to hold the interests of the company in higher regard than executive directors, who may have an agency problem or conflict of interest between management and stockholders. A non-executive director typically does not engage in the day-to-day management of the organization, but is involved in policy making and planning exercises. In addition, non-executive directors' responsibilities include the monitoring of the executive directors and acting in the interest of the company stakeholders.

Requirements for Public Company Boards in the U.S.

Public companies in the U.S. that list their equity securities on the New York Stock Exchange (NYSE) or the Nasdaq Stock Market (Nasdaq) are required to have in place a board of directors with the following features:[80]

Independent Directors

Independent directors must comprise a majority of the board. An "independent director" is one who has no material relationship with the company either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company. The company must have a minimum three-member audit committee composed of entirely independent directors.

Audit Committee

In addition to the independence requirements above, the audit committee must meet the independence requirements enumerated in Section 301 of SOX and the Securities Exchange Act Rule 10A-3(b)(1). This prohibits a director from accepting any direct or indirect consulting, advisory, or other compensatory fee from the listed company other than compensation for director service and not being affiliated with the company or its subsidiaries.

Not addressed by the NYSE, SEC Regulation S-K requires disclosure in annual reports whether or not the audit committee includes at least one "financial expert." An audit committee financial expert has an understanding of the financial statements and GAAP; experience in preparing, auditing, analyzing, or evaluating financial statements of companies comparable to the company or experience in actively supervising one or more persons engaged in such activities; experience in applying GAAP to accounting for estimates, accruals, and reserves; and an understanding of internal accounting controls, procedures for financial reporting, and audit committee functions.

Audit committee duties and responsibilities include, among others:

- To meet at least annually with the independent auditor and review the audit report describing independent auditor's internal quality control procedures.
- Discuss any material issues raised by the auditor's most recent internal quality control review or peer review of the firm, or by any inquiry or investigation by governmental or professional authorities within the preceding five years with regard to one or more independent audits carried out by the firm and steps taken to deal with any such issues.
- Discuss all relationships between the independent auditor and the company to enable assessment of the auditor's independence.
- Meet and discuss with the independent auditor and management the annual audited financial statements and quarterly financial statements, including review of Management's Discussion and Analysis of Financial Condition and Results of Operations.

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- Discuss earnings press releases and financial information and earnings guidance given to analysts and rating agencies.
- Discuss policies with respect to risk assessment and risk management.
- Meet separately, from time to time, with management, with internal auditors, and with independent auditors.
- Review with the independent auditor any audit problems or difficulties and management's response to such issues.
- Set clear hiring policies for employees or former employees of the independent auditor.
- Report regularly to the board of directors.
- Evaluate work of the audit committee annually.

Public companies also should have a compensation committee composed only of independent directors. It's best not to have the same members serve on the audit and compensation committees to reduce the likelihood of any conflict of interest.

Corporate Governance Failures at Lehman Brothers

The Great Recession that officially lasted from December 2007 to June 2009, ushered in a period of bank failures and fraud that shook the economy of the U.S. Many people blamed excessive risk taking and failed corporate governance systems. Some point out that "moral hazard" was a major contributing factor. *Moral hazard* occurs where one party is responsible for the interests of another, but has an incentive to put its own interests first. The banks used collateral debt obligations (CDOs) to repackage individual mortgage loans into a product sold to investors on the secondary market. By so doing, Lehman transferred the risk of nonpayment on these financial instruments to other parties. Given the transfer of risk, Lehman initially issued loans to uncreditworthy borrowers, knowing the bank would not be responsible if the homeowners defaulted. Unfortunately, the extra liquidity created an asset bubble in housing, credit cards, and auto debt. Housing prices skyrocketed beyond their actual value. People bought homes so they could sell them. The easy availability of debt meant people used their credit cards too much. That drove credit card debt to almost $1 trillion in 2008.

For two and a half years, the U.S. Senate focused on the role of financial institutions in the financial crisis that started with the failure of Lehman Brothers. A bankruptcy examiner's report issued on April 12, 2011, shed light on the role of auditing firms in the financial meltdown. The report was written by Jenner & Block Chairman Anton Valukas. The details of Lehman's financial activities that vaulted the company into bankruptcy are too complicated to discuss in detail, but we do provide a brief summary in Exhibit 3.3 because of its significance to the great financial recession.

At the Senate Banking Committee hearings on the Lehman failure and subsequent financial crisis, Valukas spoke about the general principle that auditors play a critical role in the proper functioning of public companies and financial markets. He said:

> Boards of directors and audit committees are entitled to rely on external auditors to serve as watchdogs—to be important gatekeepers who provide an independent check on management. And the investing public is entitled to believe that a 'clean' report from an independent auditor stands for something. The public has every right to conclude that auditors who hold themselves out as independent will stand up to management and not succumb to pressure to avoid rocking the boat. I found that [valid] claims exist against Lehman's external auditor in connection with Lehman's issuance of materially misleading financial reports.

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The Lehman failure illustrates how things can go so wrong when sound corporate governance mechanisms are not in place or not working as intended. The following is a brief description of those failures, many of which were in the area of corporate risk management.

- Failed risk management procedures brought on by excessive use of CDOs with exposure that far exceeded Lehman's understanding of the inherent risks.
- Ignoring warnings signs of liquidity risk.
- Failure to disclose material information on foreseeable risk factors.
- The Valukas report indicated that Lehman repeatedly exceeded its own internal risk limits and controls.
- Richard S. Fuld, Jr. served as chairperson and CEO.
- Make up of the board was inadequate given the complex nature of Lehman's financial transactions: only two of ten members had direct experience in the financial services industry.
- Significant payments were made to members of the board, which did not result from remuneration granted to them. These were payments from investment activity of limited partnerships set up by the company and that directors could engage.
- Top executive managers at Lehman received about $1 billion from cash bonuses and equity sales between 2000 and 2008; chairperson Fuld received close to $500 million just four days before the collapse.
- The staff owned four percent of the bank in 1994 when it went public and about 30% by 2006, mostly due to stock and options, the equivalent of $11 billion on paper.
- Ernst & Young know of potential accounting irregularities and failed to raise the issue with Lehman's board.

The relationships and activities described above illustrate a breakdown in ethics and failure of the board to exercise objective independent judgment on bank affairs. The board did not effectively monitor activities and did not meet the corporate governance standard of accountability to shareholders. It failed to meet its fiduciary responsibilities and duty of care to the shareholders. During the court process the Lehman officers stated that "Ernst & Young did not approve the Accounting Policy," instead the firm "became comfortable with the Policy for purposes of auditing financial statements."

EXHIBIT 3.3 Lehman's Financial Transactions and Accounting Irregularities

The financial recession started when Lehman Brothers failed because it was unable to retain the confidence of its lenders and counterparts and because it did not have sufficient liquidity to meet its current obligations. Lehman engaged in a series of business decisions and transactions that had left it with heavy concentrations of illiquid assets with deteriorating values such as residential and commercial real estate. Confidence eroded when Lehman reportedly had two consecutive quarters of huge reported losses, $2.8 billion in the second quarter of 2008 and $3.9 billion in the third quarter of that year.

The business decisions that had brought Lehman to its crisis of confidence may have been in error but were deemed by the bankruptcy examiner to be largely within the business judgment rule. But the decision not to disclose the effects of those judgments created a valid claim against the senior officers who oversaw and certified misleading financial statements. Legal claims of failing to meet professional responsibilities were charged against Lehman's CEO, Richard Fuld, and its CFOs, Christopher O'Meara, Erin M. Callan, and Ian Lowitt. A valid claim also existed against its external auditor, Ernst & Young, for its failure to question and challenge improper or inadequate disclosures in those financial statements, among other things.

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Lehman had used an accounting device (known within Lehman as "Repo 105") to manage its balance sheet by temporarily removing approximately $50 billion of assets from the balance sheet at the end of the first and second quarters of 2008.

In an ordinary "repo," Lehman raised cash by selling assets with a simultaneous obligation to repurchase them the next day or several days later; such transactions were accounted for as financings, and the assets remained on Lehman's balance sheet. In a Repo 105 transaction, Lehman did exactly the same thing, but because the assets were 105% or more of the cash received, accounting rules permitted the transactions to be treated as sales rather than financings, so that the assets could be removed from the balance sheet. With Repo 105 transactions, Lehman's reported net leverage was 12.1 at the end of the second quarter of 2008, but if Lehman had used ordinary repos, net leverage would have been reported at 13.9.

Lehman did not disclose its use—or the significant magnitude of its use—of Repo 105 to the federal government, to the rating agencies, to its investors, or to its own board of directors. Ernst & Young was aware of its use but did not question it or the nondisclosure of the Repo 105 accounting transactions. It took Lehman until September 2008, several months into the financial meltdown, to publicly disclose the liquidity issues. On September 10, 2008, the company announced that it was projecting a $3.9 billion loss for the third quarter of 2008. By the close of trading on September 12, its stock price had declined to $3.65 a share, a 94% drop from the $62.19 price on January 2, 2008.

Over the weekend of September 12–14, 2008, a series of meetings were held by U.S. Treasury Secretary Henry Paulson, president of the Federal Reserve Bank of New York Timothy Geithner, SEC chairman Christopher Cox, and the chief executives of leading financial institutions. The government made a decision that many believe ushered in the financial crisis. It refused to fund a solution to the Lehman problem, stating that it did not have the legal authority to make a direct capital investment in Lehman, and Lehman's assets were insufficient to support a loan large enough to avoid its collapse. The bank collapsed on September 15, when it filed for bankruptcy protection. The filing remains the largest bankruptcy filing in U.S. history, with Lehman holding over $600 billion in assets.

Ethics in the Workplace

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Discuss compliance, integrity, and employee views about ethics in the workplace.

When we think about workplace ethics, the first thing that comes to mind is a code of conduct that influences the development of an ethical culture and provides direction to steer the ethical climate toward right behavior. A code goes beyond what is legal for an organization and provides normative guidelines for ethical conduct. Support for ethical behavior from top management is a critical component of fostering an ethical climate. Employees who sense that top managers act unethically quickly lose trust in those managers. The result can be to become disillusioned with the goals of the organization and question whether the corporate culture is one that is consistent with individual, personal values and beliefs.

Here is a list of measures that should be taken to establish an ethical culture:

1. Establish clear policies on ethical conduct including a code of ethics.
2. Develop an ethics training program that instills a commitment to act ethically and explains code provisions.
3. Assign a top-level officer, such as the Chief Ethics and Compliance Officer (CECO) to oversee compliance with ethics policies.

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4. Use the internal auditors to investigate whether ethics policies have been followed in practice.
5. Establish strong internal controls to prevent and detect unethical behaviors, such as fraud.
6. Establish whistleblowing policies, including reporting outlets.
7. Establish an ethics hotline where employees can discuss questionable behavior on an anonymous basis.
8. Have employees sign a statement that they have complied with ethics policies.
9. Enforce ethics policies fairly and take immediate action against those who violate the policies.
10. Reward ethical behavior by including it in the performance evaluation system.

Compliance Function

On August 4, 2015, it was announced that the Ethics Resource Center (ERC), the oldest nonprofit advancing high ethical standards and practices in public and private institutions, and the Ethics Compliance and Officer Association (ECOA), a member-driven association for practitioners responsible for their organization's ethics and compliance programs, joined together to form a strategic alliance to become the go-to organization for ethics and compliance resources in the workplace. The resulting Ethics Compliance Initiative (ECI) provides leading ethics and compliance research and best practices, networking opportunities, and certification to its membership, which represents more than 450 organizations across all industries.

The 2016 State of Compliance study conducted by PricewaterhouseCoopers (PwC) reports on the views of 800 executives globally in three important categories: tone at the top, risk assessment, and oversight and responsibility.[81]

Tone at the Top

The results indicate a high level of senior executive support for compliance and ethics programs, but less visible engagement in leading their companies' programs.

98% have senior leadership that is committed to compliance and ethics.

55% indicate senior leadership provides only ad hoc program oversight or delegates most compliance and ethics oversight activities.

48% report their organization assesses its "tone at the top."

Tone at the top includes: (1) communicating compliance and ethics messaging to employees; (2) regularly reminding employees of the importance of ethical and compliant behavior, raising concerns, and the Company's non-retaliation policy; and (3) modeling the Company's values and demonstrating ethical and compliant behavior in everyday decision making and when enforcing disciplinary measures.

Risk Assessment

54% conduct compliance and ethics-specific risk assessment activities beyond enterprise risk management efforts.

21% use employee surveys to gather information for their risk assessments.

67% have a process to identify owners of specific compliance and ethics-related risk.

Even though 67% of respondents indicated there is a process in place in their organizations to identify owners, the study concludes organizations may be relying too heavily on the legal and/or compliance and ethics functions to manage these risk areas on a day-to-day basis. One reason for not relying on the in-house or external counsel is the lawyer's job is to defend the organization. The CECO's job is to bring

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the bad news to the boss and keep the company out of regulatory or other trouble and help to restore its reputation when ethics or compliance problems arise.

Oversight and Responsibility

20% have Boards of Directors that formed a separate, stand-alone compliance/ethics committee.

72% have dedicated business unit or business area compliance officers.

89% select compliance monitoring as a primary area of responsibility.

The study found that compliance and ethics functions have become more visible with their Boards of Directors and senior leaders. Sixty-three percent of respondents indicated their Boards receive reports on their organizations' compliance and ethics performance on at least a quarterly basis, and 67% indicated their senior leadership receives similar reports on at least a quarterly basis.

The accounting function in ethics and compliance is important. Specifically, 65% of respondents indicated that the audit committee in their organizations oversees most compliance and ethics programs. This makes sense because audit committees are responsible for oversight of internal controls over financial reporting including corporate culture and the tone at the top. The audit committee is responsible for compliance with laws such as SOX and Dodd-Frank. The committee must ensure that the audited financial statements do not contain any material misstatements due to non-compliance with SEC regulations and GAAP. The audit committee also communicates with both the external and internal auditors on matters related to compliance and ethics.

Integrity: The Basis for Trust in the Workplace

Albert Camus, the French Nobel Prize winning author, journalist, and philosopher, said, "Integrity has no need of rules." People of integrity are self-driven to do the right thing. Leaders of integrity act on the knowledge that their actions are ethical and provide the basis for others in the workplace to follow their lead.

KPMG's *Integrity Survey 2013* provides an inside look at organizational misconduct based upon responses from more than 3,500 U.S. working adults. Key findings from the report include:[82]

- Nearly three out of four employees reported that they had observed misconduct within their organizations in the previous 12 months.
- More than half of employees reported that what they observed could potentially cause a significant loss of public trust if discovered.
- Some of the driving forces behind fraud and misconduct in the corporate environment include pressure to do "whatever it takes" to meet targets, not taking the code of conduct seriously, believing employees will be rewarded based upon results and not the means used to achieve them, and fear of losing one's job for not meeting performance targets.
- Nearly half of employees were uncertain that they would be protected from retaliation if they reported concerns to management. And more than half suggested a lack of confidence that they would be satisfied with the outcome.
- Ethics and compliance programs continue to have a favorable impact on employee perceptions and behaviors.

Employees were asked what they would do if they observed a violation of their organization's standards of conduct. The results were: 78% would notify their supervisor or another manager; 54% would try resolving the matter directly; 53% would call the ethics or compliance hotline; 26% would notify someone outside the organization; and 23% would look the other way or do nothing.

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It's encouraging to learn that over three-fourths would inform their supervisor, in part because it is the generally recognized initial step in considering whether to blow the whistle. It is somewhat troubling that almost one-quarter of the workers would look the other way or do nothing. Perhaps they do not believe they would be taken seriously or a "kill the messenger" culture exists in the organization. There is also the possibility that dissonance exists if the individual has a high ethics orientation while the organization's is low.

The tone at the top set by top management is a determining factor in creating organizational commitment to high ethics and integrity. Employees were asked whether the chief executive officer and other senior executives exhibited characteristics attributable to personal integrity and ethical leadership. Approximately two-thirds of the employees agreed that their leaders set the right tone regarding the importance of ethics and integrity and served as positive role models for their organization, leaving one-third unsure or in disagreement.

Perhaps not surprisingly, a large percentage (64%) indicated that the root cause of misconduct was pressure to do "whatever it takes" to meet business objectives, while 59% said they believed they would be rewarded for results, not the means used to achieve them. In such instances, the corporate culture does not foster integrity or ethical behavior; instead, expedience and self-interest drive workplace behavior. Moreover, the findings seem to indicate a majority of respondents believe their organizations follow an end justifies the means approach to decision making: what is most important is results, not the way they were achieved.

Employees Perceptions of Ethics in the Workplace

Going beyond the Integrity Survey, it is important to understand how employees view the ethics of the organizations they work for, in part to better understand corporate governance systems and whistleblowing. The *2013 National Business Ethics Survey* (NBES) conducted by the Ethics Resource Center provides interesting data about ethics in the workplace. The report is the eighth in a series. The 2013 survey provides information on the views of 6,579 respondents that represent a broad array of employees in the for-profit sector.[83] Exhibit 3.4 summarizes observed misconduct. It is encouraging that all such instances have declined between 2011 and 2013.

EXHIBIT 3.4 2013 NBES Survey of Reporting of Observed Misconduct

Type of Misconduct	2013	2011
Stealing or theft	64%	69%
Falsifying time reports or hours worked	49%	61%
Falsifying expense reports	48%	66%
Falsifying and/or manipulating financial reporting information	45%	62%
Falsifying invoices, books, and/or records	40%	N/A
Accepting inappropriate gifts or kickbacks from suppliers or vendors	36%	52%

The results of the NBES survey depicted in Exhibit 3.5 indicate a lessening of observed misconduct, virtually no change in reporting it, and a decline in pressure to compromise ethical standards from 2011 to 2013, which may reflect an improving corporate culture. This seems to be the case since the "weak-leaning" culture response went down by 6 points in the same time period. Other results include an increase in ethics training programs and the use of ethical conduct as a performance measure in employee evaluations.

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EXHIBIT 3.5 Views of Employees on Ethics in the Workplace from the 2013 National Business Ethics Survey

Item	2013	2011	2009
Pressure to compromise ethical standards	9%	13%	8%
Weak/weak-leaning ethical culture	34%	40%	35%
Observed misconduct	41%	45%	55%
Reported observed misconduct	63%	65%	63%
Experienced retaliation after reporting (i.e., whistleblowing)	21%	22%	15%

The percentage of employees experiencing retaliation since 2009 is up, indicating it still remains a problem in corporate America. Perhaps the new protections under SOX and Dodd-Frank will help to stem the rising tide.

One concern is that, while misconduct is down overall, a relatively high percentage of misconduct is committed by managers—the very people who should be establishing an ethical culture and providing ethical leadership. Workers reported that 60% of misconduct involved someone with managerial authority from the supervisory level up to top management. Nearly a quarter (24%) of observed misdeeds involved senior managers. Also, workers said that 26% of misconduct is ongoing within their organizations and about 12% of wrongdoing was reported to take place company-wide.

Perhaps not surprising, the results indicate that occupational fraud and financial statement fraud are of greatest concern because of their effects on the accuracy and reliability of the financial statements.

Using Social Media to Criticize the Employer[84]

The National Labor Relations Act protects the rights of employees to act together in a concerted manner to address conditions at work, with or without a union. This protection extends to certain work-related conversations conducted on social media, such as Facebook and Twitter. Employees who act together on workplace issues—by, for example, meeting with a manager to lobby for better benefits or having a group discussion about the company's safety record—are protected from employer retaliation.

An activity is concerted only if it involves more than one employee's concerns. For example, employees discussing working conditions is protected. An employee who complains, after consulting with or on behalf of coworkers, that the company's performance evaluation system unfairly penalizes employees who speak up in safety meetings is engaged in concerted activity. However, an employee who complains about her own performance evaluation is not taking concerted action. As the National Labor Relations Board (NLRB) puts it, "personal gripes" are not protected. Even if employees are clearly acting in a concerted way, they won't be protected if they cross the line from constructive behavior to malicious or reckless actions.

As an example of what not to do: The former employee handbook of fast-food chain Wendy's included a rule requiring authorization before workers could make comments on social media about Wendy's business, policies, or employees. As part of an agreement with the NLRB, Wendy's social media policy now prohibits comments on "trade secrets and proprietary company information."

In 2010, the NLRB began receiving charges related to employer social media policies and to specific instances of discipline for Facebook postings. Following investigations, the agency found reasonable cause to believe that some policies and disciplinary actions violated federal labor law, and the NLRB

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Office of General Counsel issued complaints against employers alleging unlawful conduct. In other cases, investigations found that the communications were not protected and so disciplinary actions did not violate the Act.

On September 28, 2012, the NLRB found that the firing of a BMW salesman for photos and comments posted to his Facebook page did not violate federal labor law. The question came down to whether the salesman was fired exclusively for posting photos of an embarrassing accident at an adjacent Land Rover dealership, which did not involve fellow employees, or for posting mocking comments and photos with co-workers about serving hot dogs at a luxury BMW car event. Both sets of photos were posted to Facebook on the same day; a week later, the salesman was fired. The Board ruled that the salesman was fired solely for the photos he posted of a Land Rover incident, which was not concerted activity and so was not protected.

The best advice for any employee when it comes to what they post on social media is to take a step back and think about the ramifications. You might be engaging in protected speech, and you might not.

Oftentimes an employer will claim that an employee who was fired ostensibly for comments on social media was fired instead for legitimate performance reasons. In these cases, the employer must prove it would have fired them even if they had not engaged in protected concerted activity.

Human Resource mangers can't infringe on employee rights or individual rights to freedom of speech, but they can help educate employees about how to properly conduct themselves in the workplace. In this digital age, employers must develop a social media policy so employees know just what is the expected standard of behavior.

Fraud in Organizations

LO 3-7

Describe the causes of fraud, detection methods, and preventative controls.

Fraud can be defined as a deliberate misrepresentation to gain an advantage over another party. Fraud comes in many different forms, including fraud in financial statements, the misappropriation of assets (theft) and subsequent cover-up, and disclosure fraud. We introduce the concept of fraudulent financial statements in this chapter and discuss it more fully in Chapter 5. We begin by examining the results of the *2018 Global Study on Occupational Fraud and Abuse: Report to the Nations,* conducted by the Association of Certified Fraud Examiners (ACFE).

Occupational Fraud

The 2018 ACFE survey is a follow-up to three prior biennial surveys. The 2018 survey reports on 2,690 cases of occupational fraud in 125 different countries that were reported by Certified Fraud Examiners. The total cost of occupational fraud exceeded $7.1 billion.[85]

Corruption represents one of the most significant fraud risks for organizations (38%), causing a median loss of $250,000. This includes conflicts of interest, bribery, illegal gratuities, and economic extortion.

Asset misappropriation was the most common type of occupational fraud. Examples of cost and relative frequency of such schemes include: check and payment tampering (150,000; 12%); billing ($100,000; 20%); noncash ($98,000; 21%); cash larceny ($75,000; 11%); payroll ($63,000; 7%); skimming ($50,000; 11%); expense reimbursements ($31,000; 14%); register disbursements ($29,000; 3%); and cash on hand ($20,000; 15%).

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The ACFE report focuses on *occupational fraud* schemes in which an employee abuses the trust placed in him by an employer for personal gain. The ACFE defines occupational fraud as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets."[86] A summary of key findings follows:

- Survey participants estimated that the typical organization loses 5% of its revenues to fraud each year.
- The mean, or average, loss due to the frauds was $2.75 million.
- The frauds reported lasted a median of 16 months before being detected.
- Asset misappropriation schemes were the most common type of occupational fraud, comprising 89 percent of the reported cases, but causing the smallest median loss of $114,000.
- Financial statement fraud schemes made up less than 10% of the cases, but causing a median loss of $800,000.
- Occupational fraud is more likely to be detected by a tip (40%).
- Only 12% of organizations provided rewards for whistleblowers.
- Whistleblowers were most likely to report fraud to their direct supervisors (32% of cases), company executives (15%), a fraud investigation team (13%), a coworker (12%), or internal audit (10%).
- 80% of organizations reporting had a code of conduct in place at the time the fraud occurred.
- External audits of financial statements were the most commonly implemented anti-fraud control with nearly 80 percent of the organizations undergoing independent audits.
- The most prominent organizational weaknesses that contributed to the frauds was a lack of internal controls (30% of cases), followed by an override of existing controls (19%), lack of management review (18%), and poor tone at the top (10%).
- The perpetrators level of authority was strongly correlated with the size of the fraud. The median loss in a scheme committed by an owner/executive was $1 million for executives with six years or more of service but only $672,000 for those with five years or less. This is compared to managers ($200,000 for six years or more and $125,000 for five years or less) and employees ($100,000 for six years or more and $35,000 for five years or less).
- Fraudsters who had been with their company longer stole twice as much: $200,000 (5 years' tenure) versus $100,000 (less than 5 years' tenure).

How Occupational Fraud Is Committed and Detected

Asset misappropriation schemes include when an employee steals or misuses resources, such as charging personal expenses to the company while traveling on business trips. Corruption schemes include misusing one's position or influence in an organization for personal gain, something that Dennis Kozlowski was known for doing. Kozlowski and CFO Mark Swartz were convicted on June 21, 2005, of taking bonuses worth more than $120 million without the approval of Tyco's directors, abusing an employee loan program, and misrepresenting the company's financial condition to investors to boost the stock price while selling $575 million in stock.

The most common method of detection was a "tip," with 40% reporting. Additionally, 14% of tips came from an anonymous source, demonstrating that a significant portion of those who reported fraud did not want their identities known. In organizations with hotlines, 46% come from a tip but declines to 30% in organizations with no hotline. Internal audit was next with 15% followed by management review with 13%. Taken together these results indicate the need for strong internal controls

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to help prevent and detect fraud. More effective internal audits serve to strengthen internal controls, a goal of Section 404 of SOX. Exhibit 3.6 shows the frequency of detection methods as reported by survey respondents.

EXHIBIT 3.6 Initial Detection of Occupational Frauds from the *ACFE 2018 Global Study on Occupational Fraud and Abuse*

Detection Method	Percentage Reported	Median Loss
Tip	40%	$126,000
Internal Audit	15%	$108,000
Management Review	13%	$110,000
By Accident	7%	$ 50,000
Other	6%	N/A
Account Reconciliation	5%	$ 52,000
Document Examination	4%	$130,000
External Audit	4%	$250,000
Surveillance/Monitoring	3%	$ 50,000
Notified by Law Enforcement	2%	$935,000
IT Controls	1%	$ 39,000
Confession	1%	$186,000

An important point is that controls such as management reviews and internal audits account for a significant percentage of detection methods (28%), while the external audit accounts for only 4%. The point is that companies should not rely on the external audit to detect fraud but should put in place internal mechanisms to prevent and detect it.

Survey respondents provided information about how perpetrators were internally punished or dealt with. Not surprisingly, termination was the most common disciplinary action taken in occupational fraud cases (65%).

Frequency of Anti-Fraud Controls

The survey points out that while the presence of internal controls does not guarantee protection against fraud, it can help to both mitigate losses and deter some potential fraudsters by enhancing the perception of detection. Consequently, enacting internal controls specifically designed to prevent and detect fraud is a necessary part of a fraud risk management program; proactive fraud prevention and detection controls are a vital part in managing the risk of fraud.

With 40% of frauds being detected by tips, hotlines should play an essential role in organizations' anti-fraud programs. However, only 63% had a hotline mechanism in place and 12% provided rewards for whistleblowers. Exhibit 3.7 summarizes the frequency of anti-fraud controls.

Red-Flag Warnings of Fraud

Individuals who are engaged in occupational fraud schemes often exhibit certain behavioral traits or warning signs associated with their illegal activities. These are presented in Exhibit 3.8. Of particular note is living beyond one's means (41%) and financial difficulties (29%). The question is how can the anti-fraud controls identify these issues? These behavioral red flags might show up through work absences and poor performance. There may be warnings signs such as erratic behavior in the workplace.

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EXHIBIT 3.7 Frequency of Anti-Fraud Controls: 2018 ACFE Global Fraud Survey

Anti-Fraud Control	Percentage Reported
External Audit of Financial Statements	80%
Code of Conduct	80%
Internal Audit Department	73%
Management Certification of Financial Statements	72%
External Audit of Internal Controls over Financial Reporting	67%
Management Review	66%
Hotline	63%
Independent Audit Committee	61%
Employee Support Programs	54%
Anti-Fraud Policy	54%
Fraud Training for Employees	53%
Fraud Training for Managers/Executives	52%
Dedicated Fraud Department, Function, or Team	41%
Formal Fraud Risk Assessments	41%
Surprise Audits	37%
Proactive Data Monitoring/Analysis	37%
Job Rotation/Mandatory Vacations	19%
Rewards for Whistleblowers	12%

EXHIBIT 3.8 Behavioral Red Flags Displayed by Perpetrators: *2018 ACFE Global Fraud Survey*

Behavioral Indicators of Fraud	Percentage Reported
Living Beyond Means	41%
Financial Difficulties	29%
Unusually Close Association with Vendor/Customer	20%
Control Issues, Unwillingness to Share Duties	15%
No Behavioral Red Flags	15%
Divorce/Family Problems	14%
“Wheeler-Dealer” Attitude	13%
Irritability, Suspiciousness, or Defensiveness	12%
Addiction Problems	10%
Complained about Inadequate Pay	9%
Excessive Pressure From Within the Organization	7%

(*Continued*)

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Behavioral Indicators of Fraud	Percentage Reported
Refusal to Take Vacations	6%
Past Employment Related Problems	6%
Complained about Lack of Authority	5%
Excessive Family/Peer Pressure for Success	4%
Other	4%
Instability in Life Circumstances	3%

The results of the survey clearly indicate that internal auditors should have their "eyes wide open" with respect to whether managers have close relationships with outsiders that create conflicts of interest, one of the signs of ethical collapse. The results indicate that tip, internal audit, and management review accounted for 68% of frauds. That's not bad but organizations should be able to do better by strengthening their audit committee and ensuring an independent board of directors. Similarly, the internal auditors need to be aware of financial and/or personal problems of employees that might create pressures to misappropriate cash and/or create fictitious entries to cover up occupational fraud.

Example of Occupational Fraud

What follows is a description of a payroll fraud scheme. According to the ACFE study, payroll schemes accounted for 8.5% of the asset misappropriations, had a median cost of $90,000, and lasted a median of two years before being detected.

> The head of a department distributed paychecks to her employees on a weekly basis. Typically, the department head received the payroll checks each week from a payroll processing company and then distributed them to employees. One day another employee noticed the department head had locked his door after the checks were received and wondered about it. She became suspicious and reported it to his manager. A payroll audit discovered that several former employees were still receiving paychecks. It was discovered that the department head had the ability to access and edit electronic time keeping records for hourly employees and knew the passwords to the payroll system for their supervisors. She used this access to falsify hours, and thus paychecks, for previous employees. She then took the paychecks to check cashing companies to redeem them. The department head ultimately confessed to over 100 instances of payroll fraud over a 10-month period totaling almost $100,000.

In this case a lack of proper internal controls contributed to the fraud. The company lacked a proper separation of duties, did not regularly monitor payroll records for "ghost employees," did not require that employees regularly change their passwords, and allowed the department head who distributed the checks to also accept them from the payroll service. Perhaps a fraud hotline for employees to report suspicious behavior would have led to earlier reporting of the fraud.

Financial Statement Fraud

A variety of factors discourage the reporting of fraud according to a report by the Anti-Fraud Collaboration including:

- Poor tone at the top.
- Dominating and intimidating personalities.
- Mistrust.

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- Excessive team loyalty.
- Management does not want to hear about problems.
- A lack of sound policies and procedures.
- Perception that wrongdoing will not be addressed if misconduct is reported.

Participants in the study identified the following factors that potentially discourage employees from coming forward and reporting fraud:

- Fear of the unknown.
- Fear that the report will not be handled anonymously or confidentially.
- Fear that the reporter's identity will be revealed to others in the organization.
- Concern that the person perpetrating the misconduct will not be held responsible.

The potential consequences to reporting suspected fraudulent financial reporting include:

- Retaliation by co-workers.
- Termination.
- Future reputation.
- Impact on others.
- Results of investigation determine that the misconduct is unsubstantiated.
- Emotional cost of whistleblowing.

Looking at the overall results of the study, it becomes clear why employees may be reluctant to report suspected fraudulent financial reporting. Concerns whether their reports will do any good and the potential consequences for them both professionally and personally discourage reporters from coming forward. A perceived lack of support makes it more difficult to want to do the right thing and report the fraud. It all comes down to the culture of the organization and whether top management genuinely encourages the reporting of financial statement fraud or just gives lip service to it.

Financial statement fraud is discussed in greater detail in Chapter 5. Here, we introduce the term and give examples of fraud techniques to provide context for the types of transactions that raise concerns for those in the corporate governance system.

Financial statement fraud schemes occur because an employee—typically a member of top management—causes a misstatement or omission of material information in the organization's financial reports. Examples include recording fictitious revenues, understating reported expenses, artificially inflating reported assets, failing to accrue expenses at the end of the year, and accelerating the recording of revenue into an earlier period as occurred in the 3D Printing case in Chapter 1.

A report by Ernst & Young, *Detecting Financial Statement Fraud: What Every Manager Needs to Know,*[87] provides examples of common methods to overstate revenue, understate expenses, and make improper asset valuations. Revenue overstatements include the following:

- Recording gross, rather than net, revenue.
- Recording revenues of other companies when acting as a "middleman."
- Recording sales that never took place.
- Recording future sales in the current period.
- Recording sales of products that are out on consignment.

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Another would be recording revenue from increases in asset values that are not in accordance with GAAP, as Enron did by using mark-to-market accounting for for a fixed asset—power plants.

Common methods of understating expenses include the following:

- Reporting cost of sales as a non-operating expense so that it does not negatively affect gross margin.
- Capitalizing operating costs, recording them as assets on the balance sheet instead of as expenses on the income statement (i.e., WorldCom).
- Not recording some expenses at all, or not recording expenses in the proper period.

Examples of improper asset valuations include the following:

- Manipulating reserves.
- Changing the useful lives of assets.
- Failing to take a write-down when needed.
- Manipulating estimates of fair market value.

Why Does Financial Statement Fraud Occur?

Why does financial statement fraud occur? This question has been examined since the 1980s when well-publicized financial statement frauds occurred at companies including ZZZZ Best, Miniscribe, Phar-Mor, Cendant, and Waste Management. Theoretically, there are three factors that appear to be present in every case of financial statement fraud that are addressed in auditing standards.[88]

Situational pressure. Situational pressures may prompt an otherwise honest person to commit fraud. It typically occurs as a result of immediate pressure within either her internal or external environment. For example, financial analysts project earnings and companies feel the pressure to meet or exceed these amounts. An accountant may come to believe she has no option other than to go along with the fraud. The Betty Vinson situation at WorldCom is a case in point. She did not know where to turn; she was unequipped to deal with the fraud.

Perceived opportunity. The opportunity to commit fraud and conceal it must exist. People do not normally commit fraud believing they will get caught. They do it because they believe they can get away with it (i.e., have access to the underlying financial information or override internal controls). The opportunity to commit fraud and conceal it often involves the absence of or improper oversight by the board of directors or audit committee, weak or nonexistent internal controls, unusual or complex transactions, accounting estimates that require sufficient subjective judgment by management, and ineffective internal audit staff.

Rationalization. People who commit financial statement fraud are able to rationalize the act. Being able to justify the act makes it possible. The individual must first convince herself that the behavior is temporary or is acceptable. She may believe it is in the best interest of the company to commit the fraud, perhaps because a needed loan will not be secured without financial statements to back it up. There is often the belief that everything will return to normal after the trigger event has passed.

Financial statement fraud does not occur in a vacuum. It is enabled by the absence of an ethical culture. Oftentimes, a culture is created and a tone at the top established that presents the image of a company willing to do whatever it takes to paint a rosy picture about financial results. Effective oversight and strong internal controls give way to greed, moral blindness, and inattentiveness to the important details that help to prevent and detect fraud. As with most situations in business, the desire to succeed crowds out ethical behavior. Those in the way are pressured to be team players; go along just this one time; and, in the end, compromise their values.

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Corporate Governance Structures and Relationships

LO 3-8

Explain how the provisions of the Sarbanes-Oxley Act relate to corporate governance, including relationships with key parties.

In response to accounting scandals at Enron and WorldCom that caused huge losses to shareholders and led to a crisis of confidence in the financial markets, the U.S. Congress adopted the SOX in 2002.

The following is a summary of key requirements under SOX.[89]

Sarbanes-Oxley Act

Section 301

Section 301 requires publicly traded corporations to "establish procedures" for accepting employee complaints (both anonymously and non-anonymously) concerning "questionable accounting or auditing matters." Section 301 also requires independent audit committees to oversee the procedures for receiving and handling confidential whistleblower reports including (1) the receipt, retention, and treatment of reports received by the issuer regarding accounting, internal accounting controls, or auditing matters and (2) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

Section 302

Section 302 requires that principal executive and financial officers certify that they have reviewed the findings of annual or quarterly reports, and find the statements within to be accurate and free of any material errors. Those officers, normally the CEO and CFO, must also certify that they understand their responsibility for creating and monitoring internal controls within their organization, and have evaluated the effectiveness of those controls within 90 days prior to the report being issued.

Section 404

Section 404 requires public companies to include in their annual reports a report of management on the company's internal control over financial reporting. The internal control report must include a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company and management's assessment of the effectiveness of those controls. The external auditor must evaluate management's conclusions and issue its own report on the assessment of internal controls.

Section 406

Section 406 outlines code of ethics requirements for senior financial officers. A code for financial officers comprises the standards necessary to promote honest and ethical conduct; full, fair, accurate, timely, and understandable disclosure in periodic reports; and compliance with applicable governmental rules and regulations.

Section 806

Section 806 links to section 12 of the Securities Exchange Act of 1934 and prohibits "any officer, employee, contractor, subcontractor, or agent of such company" to "discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee. This includes providing information concerning

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any conduct which the employee reasonably believes constitutes a violation of any rule or regulation of the SEC, or any provision of federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by federal officials, members of Congress, and "a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct.)"

SOX also establishes the Public Company Accounting Oversight Board (PCAOB) to: (1) oversee the audit of public companies that are subject to the securities laws; (2) establish audit report standards and rules; and (3) inspect, investigate, and enforce compliance on the part of registered public accounting firms, their associated persons, and certified public accountants. PCAOB also establishes (or modifies) the auditing and related attestation standards, quality control, and the ethics standards used by registered public accounting firms to prepare and issue audit reports.

False Certifications of Financial Statements

There have been very few cases of false certifications of financial statements under section 302 of SOX that have led to sanctions by the SEC. In fact, perhaps the best-known case is one of failure to impose sanctions when sanctions were warranted. Richard Scrushy, the former HealthSouth Corporation CEO, falsely certified the financial statements of the company that had a $2.8 billion accounting fraud but was not sent to jail for that crime. On the other hand, HealthSouth CFO Weston L. Smith was sentenced in 2005 to 27 months in prison for his role in the fraud. Smith had pleaded guilty to one count each of conspiracy to commit wire and securities fraud, falsely certifying a financial report, and falsifying a report to the SEC.

The SEC's disclosure on July 30, 2014, of an enforcement action against two corporate executives of a small Florida-based computer equipment company exemplifies the type of emerging theory of fraud it is now pursuing. The commission went after both the CEO and CFO of Quality Services Group Inc. (QSGI) solely for alleged misrepresentations in public disclosures about the company's internal controls environment, which are required by SOX.

The SEC alleged that QSGI's CEO (Marc Sherman) and former CFO (Edward Cummings) knew of significant internal controls issues in the company's inventory practices that they failed to disclose to auditors and investors. Central to the SEC's theory of fraud is that Sherman and Cummings (1) signed Form 10-Ks (annual financial statements filed with the SEC) with management reports on internal controls that falsely omitted issues and (2) signed certifications in which they falsely represented that they had evaluated the management report on internal controls and disclosed all significant deficiencies to auditors.[90]

The SEC found that Sherman falsely certified in the certifications attached to the Forms 10-K and 10-K/A for the fiscal year December 31, 2008, and 10-Q (quarterly statements) forms for the quarter ended March 31, 2009, respectively, that he had: (1) evaluated QSGI's internal controls over financial reporting and (2) disclosed all significant deficiencies to the external auditors which were reasonably likely to adversely affect QSGI's ability to record, process, summarize, and report financial information. As a result, Sherman violated Securities Exchange Act Rule 13a-14 by signing false Section 302 certifications. Sherman was sanctioned by the SEC and prohibited from committing or causing any future violations of specified Securities Exchange Act rules, prohibited for five years from acting as an officer or director of any issuer that has a class of securities registered under the Exchange Act, and ordered to pay a civil monetary penalty in the amount of $7,500.[91]

So, the question in the end is, why have there not been more prosecutions under Section 302? Allison Frankel believes that the answer may lie partly in how corporations have responded to SOX. Most major corporations have implemented internal compliance systems that make it very difficult to show that the CEO or CFO knowingly signed a false certification. And when prosecutors have enough evidence to show that those internal systems failed and top executives knowingly engaged in wrongdoing, they often prefer, for strategic reasons, to charge crimes other than false certification.[92]

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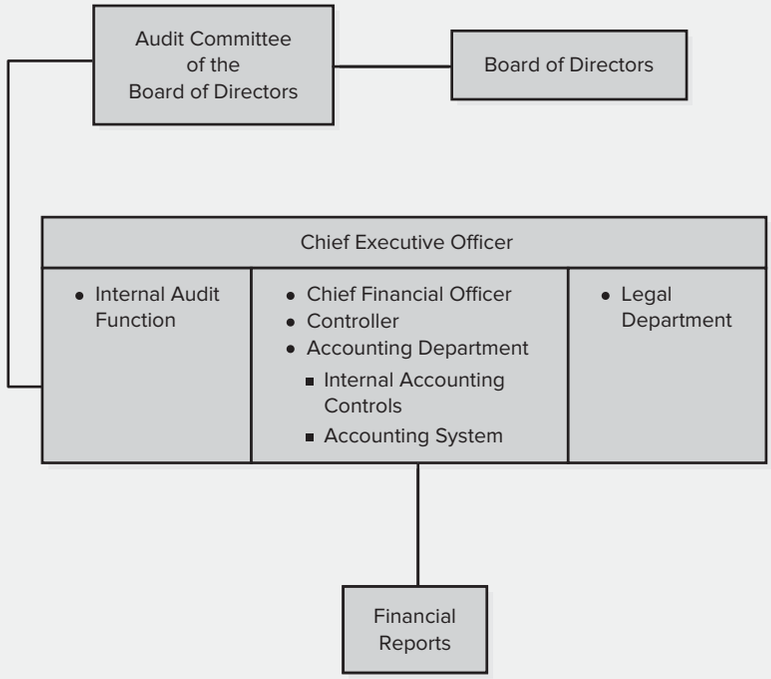
After SOX was passed, most large corporations put in place multiple layers of subcertification, requiring lower-level officials to attest to the accuracy of financial reports all the way up the chain of command to the CEO and CFO. The subcertifications forces corporations to be more vigilant about financial reporting at all levels but it also insulates CEOs and CFOs from false certification charges.

The SEC seems to be going after CFOs now because they typically mastermind financial frauds. Emboldened by legislative expansions of liability for financial executives under SOX and Dodd-Frank, the SEC increasingly is pursuing claims against CFOs that do not allege actual wrongdoing. It does so by alleging that the CFO's subordinates violated securities laws and that the CFO either certified the resulting reports or failed to implement adequate internal safeguards.

Relationships between Audit Committee, Internal Auditors, and External Auditors

Following the passage of SOX, the audit committee was seen as the one body that was (or at least should be) capable of preventing identified fraudulent financial reporting. The audit committee has an oversight responsibility for the financial statements. The internal auditors should have direct and unrestricted access to the audit committee so that they can take any matters of concern directly to that group without having to go through top management. The external auditors rely on the support and actions of the audit committee to resolve differences with management over proper financial reporting. The goal of such relationships should be to establish an ethical corporate culture that supports good corporate governance. Exhibit 3.9 depicts the ideal relationship between the internal auditors and audit committee. The framework is identified in the Treadway Commission Report titled *Report of the National Commission on Fraudulent Financial Reporting.*[93]

EXHIBIT 3.9 Internal Control Environment—"Corporate Culture"



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Audit Committee

In the accounting scandals of the early 2000s, the audit committee either didn't know about the fraud or chose to look the other way. A conscientious and diligent audit committee is an essential ingredient of an effective corporate governance system—one that takes its role in financial statement oversight to heart and follows basic principles of responsibility, accountability, and transparency.

An effective device to ensure audit committee independence is for the committee to meet separately with the senior executives, the internal auditors, and the external auditors. The perception of internal auditors as the "eyes and ears" of the audit committee suggests that the head of the internal audit department attend all audit committee meetings. Recall the role of Cynthia Cooper, the director of internal auditing at WorldCom. She informed the audit committee every step of the way as her department uncovered the fraud, and ultimately she gained the support of the external auditors.

The audit committee's duties include: (1) monitor the integrity of the financial statements; (2) review any formal announcements relating to the company's financial performance; (3) review significant financial reporting judgments contained in the statements and performance statements; (4) review the company's internal financial controls and risk management procedures; (5) monitor the effectiveness of the company's internal audit function; (6) review the company's whistleblower processes and compliance program; and (7) review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process.

The audit committee should also seek assurances from the CEO and CFO, as part of the CEO/CFO financial statement certification process under Section 302 of SOX, that they have put in place effective disclosure controls and procedures to ensure that all reports have been prepared and filed properly with the appropriate authorities in accordance with applicable requirements.

SOX calls on audit committees to create formal procedures to collect, track, and process hotline claims received by the issuer company related to accounting, internal controls, or auditing matters. Additionally, SOX holds audit committees responsible for establishing a channel for employees to submit confidential, anonymous concerns regarding questionable accounting or auditing matters through the whistleblower hotline. However, the legislation did not provide prescriptive guidance for establishing effective whistleblower programs. Because the SEC has not mandated specific processes and procedures, the audit committee plays a critical role in determining the processes appropriate for its organization.

Internal Auditors

Internal auditors interact with top management and, as such, should assist them to fulfill their role in developing accurate and reliable financial statements, ensure the effectiveness of internal control systems, and monitor compliance with laws and regulations. Specific obligations include: (1) monitor corporate governance activities and compliance with organization policies; (2) review effectiveness of the organization's code of ethics and whistleblower provisions; (3) assess audit committee effectiveness and compliance with regulations; and (4) oversee internal controls and risk management processes. Internal auditors should provide objective assurance on how effectively the organization assesses and manages its risks. A growing area of importance is to provide assurance with data security and privacy controls as will be discussed below in the Equifax data breach.

External Auditors

External auditors have an obligation to the public interest that underlies their corporate governance responsibilities. One of the primary roles of external auditors in corporate governance is protecting the interests of shareholders. This is possible because external audits should be conducted independent of any

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influence of management or the board of directors of the company. External audits should be designed to introduce a measure of accountability into the financial reporting process.

The PCAOB has recognized the importance of two-way communication between audit committees and external auditors with the adoption of Auditing Standard No. 16, *Communications with Audit Committees* ("AS 16"). Required communications include:

- Matters relating to the company's accounting policies and practices, including why certain accounting policies and practices are considered critical.
- Estimates made by management and the process used to develop these estimates, including significant changes to the process used by management to develop estimates, reasons for the changes, and the effects on the financial statements.
- The auditor's judgment about the quality of the entity's financial reporting, including the auditor's evaluation of and conclusions about the qualitative aspects of the company's significant accounting policies and practices. Auditors should also discuss significant unusual transactions and their opinion on the business rationale thereof.
- Whether the audit committee is aware of matters relevant to the audit including, but not limited to, violations or potential violations of laws or regulations, including fraud risks.

A company's audit committee is the primary link between the board of directors, management, and the independent auditors. Improving communication among these parties will play a vital role in improving the overall value of the audit for all stakeholders.

Internal Controls as a Monitoring Device

The internal controls that are established by management should help prevent and detect fraud, including materially false and misleading financial reports, asset misappropriations, and inadequate disclosures in the financial statements. These controls are designed to ensure that management policies are followed, laws are strictly adhered to, and ethical systems are built into corporate governance.

The internal control report required by Section 404 of SOX must include a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company, management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting, and a statement that the registered public accounting firm that audited the company's financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting.

An internal control system, no matter how well conceived and operated, can provide only reasonable—not absolute—assurance to management and the board of directors regarding achievement of an entity's objectives. The likelihood of achievement is affected by a variety of factors including: judgments in decision making can be faulty; breakdowns can occur due to simple mistakes and errors in the application of controls; and controls can be circumvented by the collusion of two or more people. Management override of internal controls may be a problem as well, similar to what happened at Enron and WorldCom. Indeed, the ACFE Fraud Survey found that organizations that lacked internal controls were more susceptible to asset misappropriation schemes, while corruption schemes more often involved an override of existing controls. Further, a poor tone at the top was much more likely to contribute to a financial statement fraud scheme than either of the other two categories of occupational fraud.

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COSO Framework

The system of internal controls and whether it operates as intended enables the auditor to either gain confidence about the internal processing of transactions or create doubt for the auditor that should be pursued. *Internal Control–Integrated Framework,* published by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission in 1992, establishes a framework that defines internal control as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of the following objectives: (a) effectiveness and efficiency of operations; (b) reliability of financial reporting; and (c) compliance with applicable laws and regulations.[94]

The COSO report states that management should enact five components related to these objectives as part of the framework: (1) the control environment; (2) risk assessment; (3) control activities; (4) monitoring; and (5) information and communication.

1. The *control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all aspects of internal control, providing discipline and structure.
2. *Risk assessment* is the entity's identification and evaluation of how risk might affect the achievement of objectives.
3. *Control activities* are the strategic actions established by management to ensure that its directives are carried out.
4. *Monitoring* is a process that assesses the efficiency and effectiveness of internal controls over time.
5. *Information and communication* systems provide the information in a form and at a time that enables people to carry out their responsibilities.

Enterprise Risk Management

In 2001, COSO initiated a project, and engaged PwC, to develop a framework that would be readily usable by managements to evaluate and improve their organizations' enterprise risk management. The need was there following a large number of business scandals born out of a failure of internal controls, corporate governance systems, and risk management.

According to the report, enterprise risk management enables management to effectively deal with uncertainty and associated risk and opportunity, enhancing the capacity to build value. Value is maximized when management sets strategy and objectives to strike an optimal balance between growth and return goals and related risks and efficiently and effectively deploys resources in pursuit of the entity's objectives. Of particular importance, enterprise risk management encompasses:[95]

- Aligning risk appetite and strategy–Management considers the entity's risk appetite in evaluating strategic alternatives, setting related objectives, and developing mechanisms to manage related risks.
- Enhancing risk response decisions–Enterprise risk management provides the rigor to identify and select among alternative risk responses–risk avoidance, reduction, sharing, and acceptance.

Deloitte discusses the value of risk management by pointing out that management and the Board must know beforehand the firm's capacity for risk-taking, the previously specified amount of different risks they want the firm to take, and the current and targeted risk profile relative to the desired level and capacity–to be able to evaluate and take action. This is the essence of what a risk appetite framework can do for an organization. Information needs to flow up to the Board and be presented in a timely way that drives decision making.[96]

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The capabilities inherent in enterprise risk management help management achieve the entity's performance and profitability targets and prevent loss of resources. Enterprise risk management helps ensure effective reporting and compliance with laws and regulations and helps avoid damage to the entity's reputation and associated consequences. In sum, enterprise risk management helps an entity get to where it wants to go and avoid pitfalls and surprises along the way.

COSO updated its enterprise risk management positions in *ERM Framework, Enterprise Risk Management–Integrating with Strategy and Performance.* The September 2017 revisions to the ERM framework highlight the importance of enterprise risk management in strategic planning. According to COSO's Chair, Robert B. Hirth Jr., COSO's "overall goal is to encourage a risk-conscious culture." PwC developed the framework and according to Miles Everson, PwC's Global Advisory Leader and Engagement Leader: "The Framework addresses the evolution of ERM, the benefits that can be achieved, and the need for organizations to improve their approach to managing risk."[97]

Drilling down on the Framework with respect to corporate culture, ERM suggests that each entity should link its culture–shared behaviors, emotions, and mindsets in the organization–to its strategy and risk appetite. The problem here is the ERM framework does not place sufficient emphasis on the ethical dimension of making strategic decisions opting, instead, for a focus on the entity's "hunger" for risk in terms of its strategic objectives. This tail-wagging-the-dog approach to developing an ethical culture allows management to create a culture in each situation after first determining its willingness to accept risk in developing strategic activities. Our concern is this approach sounds too much like ethical relativism because it allows each entity to define its own risk appetite rather than creating a standard built on ethical values.

Equifax Data Breach

In September 2017, Equifax disclosed that a flaw in a tool designed to build web applications created a security breach that had occurred two months prior and hackers gained access to its data. Some of the information hackers had access to included names, social security numbers, birth dates, addresses, and some driver's license numbers. The tool is called Apache Struts, and it's used by many large businesses and government organizations. A cybersecurity arm of the U.S. Department of Homeland Security "identified and disclosed" the flaw in March 2017, according to an Equifax statement. The company's security department "was aware of this vulnerability at that time, and took efforts to identify and to patch any vulnerable systems." Yet, the company admitted that hackers exploited the flaws months later. Equifax was widely criticized for waiting almost two months to alert its customers and shareholders about the hack.[98]

Congress conducted hearings to discover why the breach occurred and why it took so long for the company to inform the public about the hack of the personal information of 143 million consumers. Equifax responded by announcing that its chief information officer and chief security officer were "retiring," and that was followed by the chief executive and two other senior managers.

Francine McKenna, who writes for MarketWatch.com, points out that a company's external auditor is supposed to be an objective independent watchdog, the first line of defense for shareholders and the public when company executives and the board fail to protect them. She explains that even before the external auditors, Ernst & Young (EY), audited the financial statements of Equifax, it should have made sure the company executives set the right "tone at the top" about controls, including of its information technology systems. This was necessary to ensure Equifax was protecting its biggest asset–the consumer information it sells to banks and other organizations, which generates most of its revenues.[99]

Rani Hoitash, a Bentley University professor of accounting who is also a certified information systems auditor, told Market Watch that the assessment of cybersecurity risks is outside the scope of a financial

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statement and internal control over financial reporting audit based on auditing standards. He added, however, auditor's "are required to look at policies and practices related to financial-reporting-related information technology systems and data early in the annual audit process. If poor practices related to access controls or patch management are detected, they may not be confined to one system because these general information technology controls are not typically managed or controlled separately."[100]

Was EY asleep at the wheel? It was aware that the SEC had scrutinized Equifax for inadequate disclosures of its cyberrisk and poor overall disclosure controls. That was based on correspondence between the SEC and Equifax CEO and CFO dating from 2011 to 2014. In January 2014, the SEC asked Equifax's CEO about inadequate disclosures regarding a material weakness in internal controls over financial reporting in 2013. In its response, Equifax provided the SEC with a detailed timeline of its evaluation of the control weaknesses and concluded that its interim quarter disclosure controls were also ineffective. McKenna points out that EY's audit partner for Equifax was copied on the response to the SEC from the company's controller, along with the rest of the company's top executives. So, it appears, EY knew about the data security problems but did nothing about it.

In yet another embarrassing event for Equifax management, the U.S. Department of Justice (DOJ) announced in September 2017 that it had opened a criminal investigation into Equifax officials' stock sales just before the public disclosure of the security breach. DOJ is considering whether officials dumped nearly $1.8 million in stock just after the company discovered the breach and one month before it was announced. The company maintains the officials didn't know about the breach when they sold the stock. The SEC also announced it is investigating the possibility of insider trading.

The Equifax scandal raises some important questions in light of our discussion about internal controls, risk assessment, and the role of the internal auditors and audit committee in the data breach fiasco. A few items to consider are:

- External auditors rely on the work of internal auditors. What steps did Equifax's internal auditors take to ensure the information technology systems were operating as intended? Did it communicate this matter with the audit committee? The external auditors?
- Did the EY auditors adequately consider whether problems with the information security systems also affected the internal control systems thereby raising doubts whether the financial statements did or did not contain any material misstatements. A problem in one area of the audit heightens the possibility of problems in other areas.
- Did the company (i.e., CEO and CFO) adequately consider the controls when they certified under Section 302 that the internal controls over financial reporting were operating as intended?
- Should the SEC go after top officials of Equifax to clawback some of its executive compensation during the period nothing was done about the data breach even though the company was well aware of it?

The Equifax case illustrates what can happen when management seeks to protect its own interests and that of the company without regard to its responsibilities to consumers and the public. The audit deficiencies seem to be a fallout of the fraud. One concern we have is whether the EY auditors made a good faith attempt to understand information technology controls and how they may have influenced the internal controls over financial reporting.

We also are concerned about the role that "risk tolerance" may have played in the company's evaluations. The ERM document says that each entity should link its culture to its strategy and risk appetite, focusing on its "hunger" for risk. Does this mean that Equifax might have, knowingly or unknowingly, decided the risk of a data breach was acceptable because its risk tolerance was very high?

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Whistleblowing

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Analyze the moral basis for whistleblowing and accountants' obligations to whistle blow.

There is a symbiotic relationship between whistleblowing and an organization's culture. Effective internal whistleblowing processes are an important part of a healthy corporate culture. Internal auditors have a critical role to play in monitoring whistleblowing procedures, given the nature of internal control. The audit committee should ensure that matters of concern are raised through appropriate channels and promptly dealt with. Whistleblowing should be part of the internal control environment and an effective corporate governance system.

There is no one set definition of whistleblowing, although most definitions characterize the practice as disclosing to others in an organization an action that violates organizational norms or the law. Near and Miceli take a broad view of whistleblowing as "the disclosure by organization members (former or current) of illegal, immoral, or illegitimate practices under the control of their employers, to persons or organizations that may be able to effect action." This definition includes whistleblowers who use internal channels (e.g., a hotline or ombudsperson) or external channels (e.g., the external auditors or the SEC) to blow the whistle. They identify four elements of the whistleblowing process: the whistleblower, the whistleblowing act or complaint, the party to whom the complaint is made, and the organization against which the complaint is lodged. In discussing the act itself, they label it as an act of "dissidence" somewhat analogous to civil disobedience.[101]

Morality of Whistleblowing

Given that the act of whistleblowing is a personal choice, the key to whether an individual will blow the whistle on wrongdoing is whether the whistleblower perceives organizational policies are designed to encourage moral autonomy, individual responsibility, and organizational support for whistleblowers.

Whistleblowing always involves an actual or at least declared intention to prevent something bad that would otherwise occur. It always involves information that would not ordinarily be revealed. Most ethicists agree whistleblowing is an ethical action. According to the "standard theory" on whistleblowing of Michael Davis, whistleblowing is morally required when it is required at all; people have a moral obligation to prevent serious harm to others if they can do so with little costs to themselves.[102]

DeGeorge analyzes when whistleblowing is a moral act. His starting position is based on the universal ethical principle that "corporations have a moral obligation not to harm." DeGeorge identifies five criteria when whistleblowing is morally permitted: (1) the firm's actions will do serious and considerable harm to others; (2) the whistleblowing act is justifiable once the employee reports it to her immediate supervisor and makes her moral concerns known; (3) absent any action by the supervisor, the employee should take the matter all the way up to the board, if necessary; (4) documented evidence must exist that would convince a reasonable and impartial observer that one's views of the situation is correct and that serious harm may occur; and (5) the employee must reasonably believe that going public will create the necessary change to protect the public and is worth the risk to oneself.[103]

DeGeorge's criteria establish the foundation for moral behavior to occur when contemplating whistleblowing. He rejects the position that external whistleblowing is *always* morally justifiable, and also rejects the position that external whistleblowing is *never* morally justifiable. Basically his position is that the whistleblower should have a moral motivation to engage in the act (i.e., to expose unnecessary harm and illegal or immoral actions).

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Rights and Duties

Researchers have posed the question of whether workplace whistleblowing is a right, and thus allows for responsible behavior, or whether it is an imposed corporate duty, thus resulting in liability of workers. If an organization institutes an internal whistleblowing policy, it is because it perceives moral autonomy to be weak so that employees need direction when and how whistleblowing should occur. When businesses then implement the policy, it leads to the conclusion that moral autonomy is strong, and employees are expected to blow the whistle.[104] Therefore, if employees do not blow the whistle in accordance with corporate policy, they then become liable for not doing so, rendering the policy a tool that controls employee behavior. Responsibility for misdeeds then shifts from the organization to the individual, and employees are further stripped of the right to moral autonomy.[105]

Miceli and Near's research has shown that what whistleblowers hope and believe their speaking out will achieve is the correction of what they perceive as an organizational wrongdoing (e.g., fraudulent financial statements). This research also found that not everyone who perceives a wrongdoing acts upon that perception. In fact, only 42% stated they were ready to blow the whistle. Those who observe wrongdoing but would not do so identify a "retaliatory climate" in their organizations as the primary barrier to blowing the whistle on corporate wrongdoing, while those who say they would speak up about it were confident that they "would not experience managerial retaliation if they blew the whistle."[106]

Whistleblowing regulations attempt to protect individuals when they behave responsibly toward society in light of irresponsible behavior by their organizations. This certainly is the motivation for the anti-retaliation provisions of both SOX and Dodd-Frank. The acknowledgement of the need for such protection, however, implies that moral agency, autonomy, and responsibility are problematic in organizations, or at the very least, that they do not come naturally and are not welcomed when they arrive. When organizations establish an ethical culture and anonymous channels to report wrongdoing, they create an environment that supports whistleblowing and whistleblowers while controlling for possible retaliation.[107]

Anthony Menendez v. Halliburton, Inc.[108]

Doing the right thing and blowing the whistle does not always pay off and can be an arduous task. A case in point is what happened to Anthony Menendez in his whistleblowing ordeal with Halliburton. One day in February 2006, he received an e-mail from Halliburton's chief accounting officer, Mark McCollum, that was addressed to much of the accounting department. It read, "The SEC has opened an inquiry into the allegations of Mr. Menendez." Everyone was told to retain their documents until further notice. Menendez had been outed. Thus began a nine-year ordeal to clear his name.

The key accounting issue was how to recognize revenue when goods are held for the customer in the seller's warehouse and not shipped pending customer request. Halliburton was engaging in "bill-and-hold" transactions. To meet the GAAP requirements to recognize revenue on these transactions, the following four criteria must be met: (1) the risks of ownership must have passed to the buyer; (2) delivery must be for a fixed date; (3) the seller must not retain any significant performance obligations; and (4) the goods or equipment must be complete and ready for shipment. Menendez knew the first criteria couldn't be met and in most cases neither could the second. All efforts to convince the company it was prematurely recognizing revenue were met with resistance because the company was under pressure to meet financial analysts' earnings projections. The KPMG auditors went along despite Menendez's efforts to convince them of the GAAP violation. Once he had been retaliated against, Menendez decided to lodge a complaint with the SEC under SOX.

The facts of the case are summarized in Exhibit 3.10. (An expanded version of this case with multiple areas for discussion appears in Case 3-8).

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EXHIBIT 3.10 Accountant Takes on Halliburton and Wins

Tony Menendez was the Director of Technical Accounting Research and Training at Halliburton. Halliburton contracts with energy companies like Royal Dutch Shell and BP to find and exploit huge oil and gas fields. It sells services of its geologists and engineers who work intricate machinery that Halliburton built and sold to its customers. The company's accountants had been allowing the company to count the full value of the equipment right away as revenue, sometimes even before it had assembled the equipment. But the customers could walk away in the middle of the contracts. Menendez knew that if the equipment were damaged, Halliburton, not the customer, absorbed the loss. Menendez recommended the company wait until the work was completed to record the equipment sales as revenue.

Even though top Halliburton accounting executives, including Halliburton's chief accounting officer, Mark McCollum, agreed with Menendez's analysis, they didn't act to correct the accounting because of concern about its impact in slowing revenue growth. McCollum tried to dissuade Menendez by reminding him of the need to be a team player and that his persistence was not well received by colleagues. He told Menendez that the Halliburton team, working with the external auditors from KPMG, had reached a different conclusion. He also offered that Menendez shouldn't put things in writing and had to be more "circumspect about the use of e-mail to communicate." He finished by telling Menendez that he wasn't asking him to compromise his ethics and compromise the position he felt so strongly about.

Menendez waited to see what would happen. Given that billions in equipment sales were involved, he knew this was no trivial matter. Finally, in the fall he realized nothing would happen. Menendez agonized and several days later filed a confidential complaint with the SEC in November 2005.

He spoke to the SEC about the matter and was told to go to the audit committee. Menendez assumed the SEC would take action, but nothing seemed to occur, until February 4, 2006, when he heard the SEC was poking around.

Unbeknownst to Menendez, his complaint went to the Halliburton legal department as well as the board committee, an apparent violation of company policy. The audit committee was supposed to keep such reports confidential. A few days later, the SEC notified the company that it had opened an investigation into the company's revenue recognition. Then, the e-mail from McCollum got distributed. Halliburton's general counsel said "the SEC is investigating Mr. Menendez's complaints" to the company's chief financial officer, KPMG, other top executives, and McCollum. McCollum had forwarded it to at least 15 of Menendez's colleagues in accounting. As far as Halliburton was concerned, they had a traitor in their ranks.

The ramifications were immediate. Menendez was stripped of his responsibilities and became a pariah at the firm. Halliburton contracted with an outside law firm to conduct an "investigation." Not surprisingly, it cleared the company. The SEC informed Halliburton it would not bring any enforcement action against it.

Menendez went back to the SEC to no avail. The commission wouldn't even accept the documents he had provided. Finally, he felt he had to leave Halliburton having been punished for blowing the whistle. He brought a claim under SOX in May 2006 based on retaliation, but the government would not take up his case. He brought separate lawsuits, but lost. He persisted even when others told him he had no chance of prevailing. No one would take his case. Finally, he decided to represent himself in the appeals process. It went on for more than five years. In September 2011, the administrative laws appeals panel had ruled. It overturned the original trial judge.

Halliburton appealed the reversal. Another two years went by and in April 2013, the appeals panel ruled that he had been retaliated against for blowing the whistle, just as he had argued all along.

Menendez acted on principle in his quest for the truth. He only wanted to be proven right so he had asked for a token sum. The panel, noting the importance of punishing retaliations against whistleblowers, awarded him $30,000.

Menendez's case was filed before Dodd-Frank became effective. It is interesting to contemplate what might have happened had he filed a whistleblower claim under the act. Would he have been rewarded for his efforts?

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Dodd-Frank Provisions

The Dodd-Frank Wall Street Reform and Consumer Protection Act was adopted by Congress on January 5, 2010, and became effective on August 12, 2011.[109] It changes the regulatory landscape for internal accountants and auditors, and external auditors and auditing firms, by protecting whistleblowers that "voluntarily" provide the SEC with "original information" about a violation of federal securities laws that leads to a successful enforcement proceeding. Under the United States Code, the enforcement action must result in monetary sanctions of more than $1 million.[110]

Dodd-Frank defines a whistleblower as any individual who provides information to the SEC relating to a violation of the securities laws that has occurred, is ongoing, or is about to occur. *Voluntarily* means the whistleblower has provided information prior to the government, a self-regulatory organization, or the PCAOB asking for it directly from the whistleblower. Original information must be based upon the whistleblower's independent knowledge or independent analysis, not already known to the SEC and not derived exclusively from an allegation made in a judicial or administrative hearing or a governmental report, hearing, audit, or investigation.[111]

Section 922 of Dodd-Frank provides an award for whistleblowers (who meet certain criteria) of "not less than 10% and not more than 30%, in total, of what has been collected of the monetary sanctions imposed in the section." Kastiel believes the award incentivizes whistleblowing and provides a bounty hunter's payment for disclosing the relevant information to the SEC.[112] This raises the question: Is it ethical to provide financial incentives to motivate employees to come forward and report financial wrongdoing? This is not an easy question to answer.

One major concern with Dodd-Frank is that it may cause would-be whistleblowers to go external with the information rather than internally using the organization's prescribed reporting mechanisms. The disclosure of confidential information about clients raises questions about a possible violation of Section 1.320.001 of the AICPA Code and of state privilege laws.[113] The external disclosure of confidential information can, under certain circumstances, be treated as an exception to the rule if disclosure is linked to compliance with applicable laws and government regulations, which include Dodd-Frank. The act defines the circumstances under which the disclosure of confidential information by external auditors will not violate confidentiality and entails a good faith effort to get the company or client to alter the accounting that triggers the concern.

We believe that once the internal reporting process has played out and nothing has been done to correct for the wrongdoing, from an ethical perspective, external whistleblowing is the proper course of action, especially if it is the *only* way for the public to know. An employee should not fall victim to the bystander effect and assume others will report it. Along with knowledge comes the responsibility to correct wrongdoings, which is in the best long-term interests of the organization.

Internal Accountants' Eligibility

Under Dodd-Frank, internal accountants are excluded from receiving whistleblower awards because of their pre-existing legal duty to report securities violations.[114] This includes individuals with internal compliance or audit responsibilities at an entity who receive information about potential violations since it is part of their job responsibilities to report suspicion of illegal acts and fraud to management.

Internal accountants are eligible to become Dodd-Frank whistleblowers in three situations: (1) disclosure to the SEC is needed to prevent "substantial injury" to the financial interest of an entity or its investors; (2) the whistleblower "reasonably believes" the entity is impeding investigation of the misconduct (e.g., destroying documents or improperly influencing witnesses); or (3) the whistleblower has first reported the violation internally and at least 120 days have passed with no action.

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The substantial injury provision does not require the whistleblower to reasonably believe that the entity might commit a "material violation"; rather, the whistleblower will generally only need to demonstrate that responsible management or governance personnel at the entity were aware of an "imminent violation" and were not taking steps to prevent it. The 120-day "look-back" period begins after the internal accountant or auditor either provided information of a possible violation to the relevant entity's management (i.e., audit committee, chief legal officer, or chief ethics and compliance officer), or at least 120 days have elapsed since the whistleblower received the information, if the whistleblower received it under circumstances indicating that these people were already aware of the information. The internal accountant cannot become eligible for a whistleblower award by learning of possible misconduct, realizing that those responsible for the entity's compliance are not aware of the possible misconduct, failing to provide the information to them, waiting for the 120-day period to run, and then reporting the information to the SEC (SEC 2010).[115]

External Auditor Eligibility

External auditors are generally prohibited from blowing the whistle on their clients because the information gained during a mandated audit would not be considered to derive from an individual's independent knowledge or analysis. The Dodd-Frank Act prohibits an external auditor who is already obligated to report information to the SEC from personally profiting from reporting that same information as a whistleblower. However, for auditors and their firms, the whistleblower rules allow the auditor or an employee associated with the auditor to make a whistleblower submission alleging that the firm failed to assess, investigate, or report wrongdoing in accordance with Section 10A or that the firm failed to follow other professional standards.

Section 10A of the Securities Exchange Act sets out prescribed steps to take before deciding whether to inform the SEC of fraud.

1. Determine whether the violations have a material effect, quantitatively or qualitatively, on the financial statements.
2. If yes, has management, or the board of directors, caused management to take remedial action, including reporting externally if necessary?
3. If no, then the auditor must make a formal report of its conclusions and provide the report to the board. The board then has one business day to inform the SEC and provide a copy of the communication to the external auditor. If the auditing firm does not receive a copy within one business day, then it has two choices:
    a. Provide a copy of its own report to the SEC within one business day, or
    b. Resign from the engagement and provide a copy of the report to the SEC within one business day of resigning.

If the whistleblower makes such a submission to the SEC based on the firm's failure to follow Section 10A, the whistleblower will be able to obtain an award not only from a successful enforcement action against the auditing firm, but also from any successful action against the firm's engagement client. In allowing such claims, the goal of the SEC is to "help insure that wrongdoing by the [accounting] firm (or its employees) is reported on a timely fashion." According to the SEC, this goal is paramount "because of the important gatekeeper role that auditors play in the securities markets."[116]

Rosenthal and Smith point out that several members of the public accounting profession, including KPMG, Ernst & Young, PricewaterhouseCoopers, and the Center for Audit Quality, believe that permitting CPAs to obtain monetary rewards for blowing the whistle on their own firms' performance of services for clients could create several significant problems including: (1) undermining the ethical obligations of CPAs not to divulge confidential client information by providing a financial reward for whistleblowing; (2) harming

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the quality of external audits because client management might restrict access to client information for fear the financial incentive for whistleblowing could lead to reporting client-specific information to the SEC; (3) overriding the firms' internal reporting mechanisms for audit-related disagreements; and (4) incentivizing an individual to bypass existing programs to report disagreements including hotlines.[117]

Integrity Considerations

The Integrity and Objectivity rule in the AICPA Code requires that "In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others [1.100.001]."[118] This rule includes subordination of judgment issues when differences of opinion exist either between an internal accountant and his or her supervisor within the client entity as well as differences between an external auditor and the audit firm. The process to follow is depicted in Exhibit 3.11.

The basic consideration is whether threats exist to compliance with integrity and objectivity that cannot be resolved through adequate safeguards. These threats exist when differences of opinion on accounting matters are present. Under Sections 1.100.001 and 1.130.020, when differences of opinion exist on how best to handle disagreements with one's superior within the entity, or the auditor and audit firm, and the required adjustments are not made, then the CPA should consider whether safeguards exist to ensure that threats to compliance with the rules are eliminated or reduced to an acceptable level. Assuming the difference is between the internal accountant and her supervisor (i.e., the CFO), the internal accountant should determine whether internal reporting requirements exist within the entity to report differences of opinion and any responsibilities that may exist to communicate with third parties, such as regulatory authorities. In that regard, the CPA is advised to seek legal advice on the matter.

If the internal accountant concludes that safeguards cannot eliminate or reduce the threats to integrity and objectivity to an acceptable level or other appropriate action was not taken, then the accountant should consider whether the relationship with the organization should be terminated including possibly resigning one's position. These steps are necessary to prevent subordination of judgment.

The ethical standards in the AICPA Code, SOX provisions, and Dodd-Frank reporting requirements are all part of a healthy corporate governance system. The rules provide the foundation for professional obligations and when to report differences within the corporate governance system. SOX provides steps to ensure the underlying features of a strong corporate governance system exist and are operating as intended. Dodd-Frank addresses whistleblowing considerations when the corporate governance system has not worked as intended to rectify deficiencies in the financial statements. An ethical company is one that embraces these requirements and instills them in the corporate culture.

Whistleblowing Experiences

Since 2012, the SEC's whistleblower program under Dodd-Frank has paid more than $175 million to whistleblowers who provided the SEC with unique and useful information that contributed to a successful enforcement action. In 2016 alone, the office issued more than $57 million to 13 whistleblowers, including six of the ten largest whistleblower awards in the program's history. The details of most awards are not publicly available because many whistleblowers file anonymously through attorneys. However, we can learn a lot from the awards with respect to the types of incidents that trigger awards, confidentiality considerations, and whistleblowing and retaliation by the offenders.[119] Here are a few examples.

- September 29, 2016. The SEC ordered International Game Technology to pay a $500,000 penalty for terminating the employment of a whistleblower because he reported to senior management and to the SEC that the company's financial statements might be distorted.

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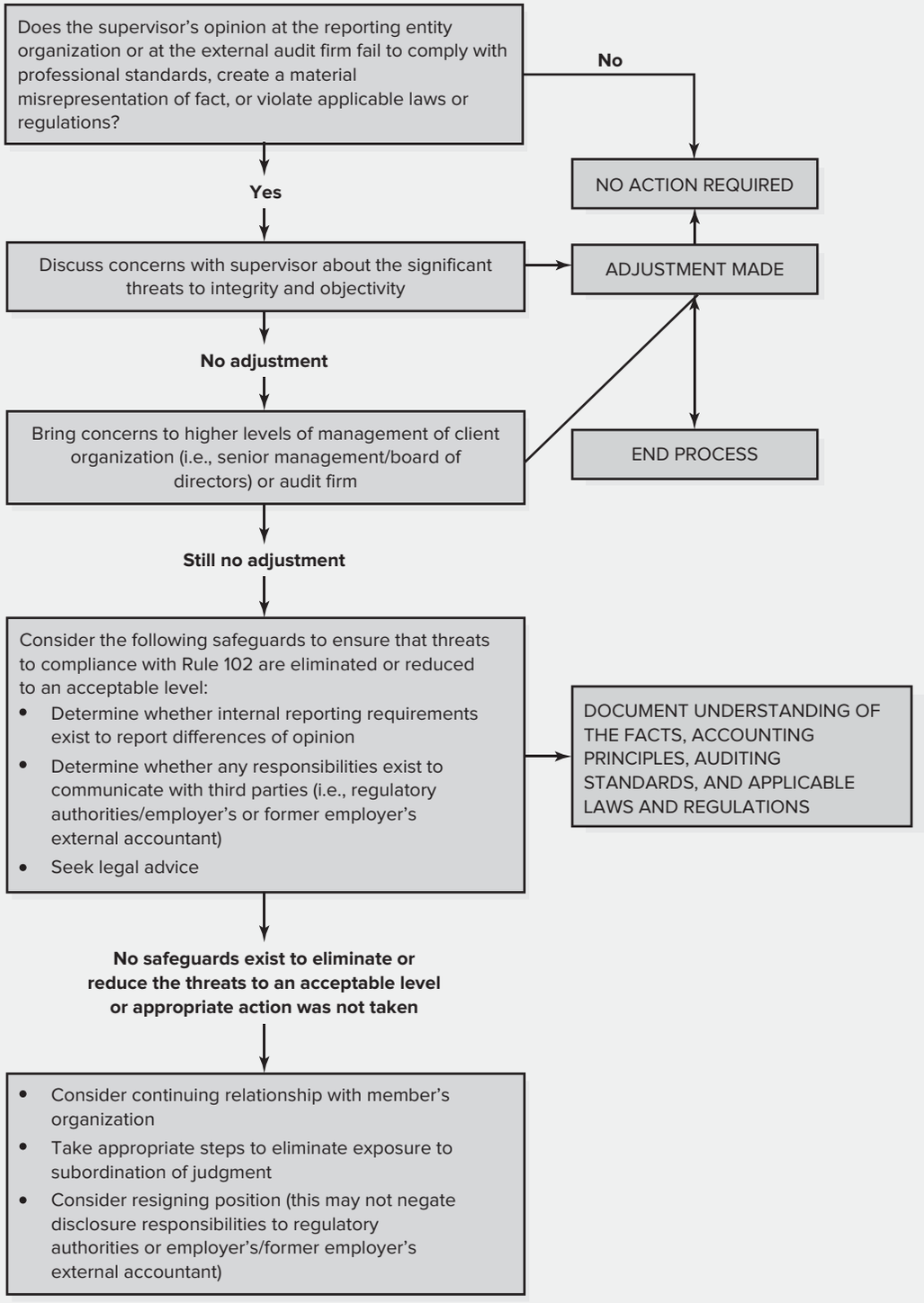
EXHIBIT 3.11 Ethical Responsibilities of CPAs to Avoid Subordination of Judgment*



*Source: Exhibit 3.11 was developed by the author from AICPA Code Section 1.130.020

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- August 30, 2016 ($22 million award). A former financial executive at Monsanto exposed weaknesses in the company's internal controls that failed to account for millions of dollars in rebates. Monsanto agreed to settle the allegations of accounting fraud for $80 million.
- August 10, 2016. The SEC issued a cease-and-desist order against BlueLinx Holdings for including provisions in severance agreements that would require former employees to waive the right to recover a whistleblower award and agree to notify the company's legal counsel before disclosing information to government agencies pursuant to legal process.
- April 1, 2015. The SEC took administrative action against KBR Inc. for requiring witnesses in certain internal investigations to sign confidentiality statements with language threatening disciplinary action, including termination of their employment, if they discussed the subject of the interviews with outside parties without prior approval from the company's legal department.

While we believe the whistleblowing program is the right thing to do to protect the public interest, we are concerned about two things:

1. A self-interested and opportunistic person may be induced to reveal company information to the SEC after following the prescribed internal compliance process, that led to no action by the company, with inadequate safeguards as to the quality of the information provided, and
2. Permitting compliance officers to become whistleblowers merely because of the passage of time (i.e., 120 days), rather than on a case-specific consideration of whether the company adequately addressed the underlying compliance issues in good faith, can erode corporate culture and trust in compliance officials; the result may be to subvert the overarching objectives of preventing, detecting, and remediating corporate misconduct on an enterprise-wide basis.[120]

We agree with others who have pointed out that, by reporting through the internal compliance process, others in the organization become informed of the facts and become potential whistleblowers.[121] As a practical matter, there may be no way around widening the circle of those in the know, but organizations should, at a minimum, take steps to protect the identity of the whistleblower.

Implications of Supreme Court Decision in *Digital Realty Trust, Inc. v. Somers*

On February 21, 2018, the U.S. Supreme Court issued an opinion in *Digital Realty Trust, Inc. v. Somers*[122] that whistleblowers are not protected against retaliation under Dodd-Frank unless they report the matter to the SEC, even if they report wrongdoing internally. The Court overruled a decision by the 9th Circuit Court of Appeals that sided with Paul Somers, formerly a vice-president of Realty Trust, who was terminated as a result of his reports to senior management regarding possible securities law violations. The lower Court ruled in his favor but the Supreme Court reversed the decision because Somers did not make any disclosure of the alleged misconduct to the SEC.

The controversial decision lessens protections for employees under Dodd-Frank who are retaliated against and may drive them to the SEC sooner rather than later. That may not be a good thing for employers who saw the *Digital Realty* decision as a win. It appears that employees can still qualify for the bounty hunter award under Dodd-Frank because they have to report the alleged wrongdoing to the SEC to enable it to institute legal action against the employer.

The key issue in the *Digital Realty* case was the interpretation of who is a whistleblower under Dodd-Frank and when does a would-be whistleblower qualify for protection against retaliation. The statute defines a whistleblower as a person who reports potential violations of the securities laws to the SEC. Under the

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anti-retaliation provisions, an employer is prohibited from discharging, harassing or otherwise discriminating against a whistleblower because of the whistleblower's having made protected disclosures in any of three situations: (1) providing information to the SEC, (2) testifying or assisting in the SEC's investigation, and (3) "making disclosures that are required or protected under" SOX, the Securities Exchange Act, specified criminal anti-retaliation prohibitions or "any other law, rule, or regulation subject to the jurisdiction of the Commission."[123]

The SEC had been interpreting the Act with respect to the retaliation provision broadly thereby allowing the protections to apply to internal company reporting even if the individual did not report to the SEC. The Supreme Court disagreed with that interpretation. Writing for the Court in its 9-0 unanimous decision, Justice Ruth Bader Ginsburg put it this way: "A whistleblower is any person who provides . . . information relating to a violation of the securities laws *to the Commission*" [emphasis added]. "That definition," she added, "describes who is eligible for anti-retaliation protection if the individual engages in any of the protected conduct enumerated in the three clauses." Moreover, she observed, "this interpretation is consistent with the 'core objective' of Dodd-Frank's robust whistleblower program," . . . [which] is 'to motivate people who know of securities law violations to *tell the SEC.'*" That's why, for example, the program provides for substantial monetary rewards for SEC reporting. By comparison, SOX had a broader mission to "disturb the 'corporate code of silence' that 'discourage[d] employees from reporting fraudulent behavior not only to the proper authorities, such as the FBI and the SEC, but even internally.'"[124]

As for auditors, attorneys and other employees who are subject to internal-reporting requirements, they are protected under the provision as soon as they also report to the SEC. This has significant implications for accountants and auditors who are CPAs. Rule 1.130.020 of the AICPA Code, that is depicted in Exhibit 3.11, calls for accounting professionals to first meet their internal reporting obligations and then and only then to determine whether any responsibilities exist to communicate with third parties (i.e., the SEC). Consider what might happen if a controller uses the internal reporting mechanisms and, during the process, is fired by the company. It would seem to be too late at that point to inform the SEC and qualify for whistleblower protection. Filing under the Sarbanes-Oxley Act may be an option but there is only a 180-day window of opportunity after the date on which the employee became aware of the violation. Dodd-Frank actions have a shelf life of three years in most cases.

The bottom line on the Supreme Court decision, at least for most employees, is whether they go to the SEC immediately even before they report the matter internally to ensure they qualify for Dodd-Frank protections. Accounting professionals have a tougher decision since they are professionally and ethically obligated to use the internal chain of command first before reporting to the SEC. The Supreme Court may have turned Dodd-Frank, and whistleblowing in general, on its head. Only time will tell whether employees rush off to the SEC to seek protection rather than try and resolve differences internally first. For now, a cynic might say you should go to the SEC and report wrongdoing then risk being fired and then go back to the SEC and claim retaliation.

Whistleblowers Can Use Confidential Company Documents to Expose Fraud

On January 26, 2018, Charles Matthew Erhart struck a blow for all would-be whistleblowers when he achieved a significant win on a critical challenge that nearly all corporate whistleblowers often face—whether they can use confidential company documents to expose fraud and other illegality. District Court Judge Cynthia Bashant's decision in *Erhart v. BofI Holdings*[125] clarifies that employer confidentiality agreements do not supersede federal whistleblower rights, and signals that retaliatory lawsuits against whistleblowers are unlikely to succeed. The decision also provides important guidance to corporate whistleblowers concerning precautions to take in using company documents to blow the whistle.

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Erhart worked for BofI Federal Bank (BofI) as an internal auditor and sued BofI under the Sarbanes-Oxley Act and other whistleblower protection laws. Erhart alleged that BofI terminated his employment in retaliation for disclosing to the bank and federal regulators numerous violations of federal and state law. In particular, Erhart's whistleblower retaliation complaint alleged that he opposed the bank's decision to withhold information that was clearly responsive to an SEC subpoena and disclosed improprieties in the CEO's personal accounts and potential violations of bank rules.

Shortly after Erhart filed his retaliation claim, BofI further retaliated against him by suing him for alleged theft and dissemination of BofI's confidential information. In particular, BofI brought claims for (1) breach of contract; (2) conversion; (3) breach of the duty of loyalty; (4) negligence; (5) fraud; (6) violation of the Computer Fraud and Abuse Act; (8) unfair business practices; and (9) other violations of federal and state law.

The key aspects of the decision follow.

Confidentiality Agreements Do Not Trump Whistleblower Rights

The public policy protecting whistleblowers from retaliation, which is reflected in the Dodd-Frank Financial Reform Act and Sarbanes-Oxley, precludes companies from interfering with or preventing whistleblowing. In particular, an SEC rule implementing the Dodd-Frank whistleblower reward program bars companies from "enforcing, or threatening to enforce, a confidentiality agreement" to impede communicating with the SEC. Judge Bashant held that the "public policy in favor of whistleblower protection clearly outweighs the interest in the enforcement of [BofI's confidentiality] agreement, and the agreement is unenforceable."

Appropriating Company Documents is Protected Whistleblowing in Certain Circumstances

Judge Bashant held that whistleblowers are permitted to take company documents to disclose fraud to the government for two reasons. First, "whistleblowers often need documentary evidence to substantiate their allegations." Second, "[a]llowing a whistleblower to appropriate documents supporting believed wrongdoing also mitigates the possibility that evidence of the wrongdoing will be destroyed before an investigation can be conducted."

However, Judge Bashant also held that if a whistleblower engages in wholesale stripping of confidential documents or where the appropriation of confidential documents is "vast and indiscriminate," the public policy in favor of whistleblower might not immunize the whistleblower from potential liability. Here, Judge Bashant declined to reject Erhart's whistleblower defense to the appropriation claims because (1) Erhart testified in a declaration that he "was very careful in [selecting] the information [he] accessed and turned over. Each document was specifically related to one of the allegations of wrongdoing [he] had discussed with [his supervisor] and then reported to federal law enforcement"; and (2) Erhart states that "every document" he used was one he "had properly accessed in the course of performing [his] work as an internal auditor."

Disclosure of Confidential Information in a Retaliation Complaint Should Be Limited to What is Reasonably Necessary to Pursue the Claim

Judge Bashant rejected BofI's position that its confidentiality agreement barred Erhart from using any confidential information to pursue his retaliation claims. But she also noted that Erhart should be permitted to disclose BofI's information in his complaint if doing so was "reasonably necessary" to pursue his retaliation claim.

Taken together with the *Digital Realty Trust, Inc. v. Somers* ruling, these two court decisions seek to protect whistleblowers at the cost of harming employer interests. It remains to be seen whether these rulings result in more whistleblower activity against employers and increased involvement of the SEC at an earlier stage to shut down financial wrongdoing sooner rather than later.

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Concluding Thoughts

It is essential for all organizations to take reasonable steps to ensure that they develop an ethical culture, enhance ethical climate by clearly defining right behavior through a code of ethics and ethics policies, and set an ethical tone at the top that encourages responsible behavior. Corporate governance is a key element of an ethical environment. Strong internal controls, an independent audit committee, periodic meetings between independent directors and the external auditors, and a clearly defined whistleblowing policy all contribute to an effective corporate governance system. Research supports the proposition that "strong ethical cultures" diminish organizational misconduct and thereby the need for employees to blow the whistle internally or externally.[126]

Creating an ethical culture is a necessary but insufficient condition to ensure that ethical behavior occurs. Individuals within the organization may attempt to subvert the systems and pressure others to look the other way or go along with wrongdoing under the guise of being a team player or accepting a one-time fix to a perceived problem. In these situations, outlets should exist for employees to voice their values when they believe unethical or fraudulent behavior has occurred. Just imagine how Anthony Menendez's experiences would have changed had Halliburton created such a supportive environment.

Employees who have made a good faith effort to report material misstatements in the financial statements or violations of applicable laws and regulations to top management and the board of directors to no avail now have the option of informing the SEC under SOX and be protected against retaliation. Dodd-Frank provides a whistleblower award to incentivize internal accountants and external auditors to report fraud after following the prescribed procedures so that management has an opportunity to adjust the financial statements. These are important parts of a healthy corporate governance system but may not solve the underlying problem, which is a tone at the top that says: This is the way things are done around here. It takes a strong commitment to ethics of those in the organization to change the culture and align ethical action with ethical beliefs.

Discussion Questions

1. What are the ethical lessons to be learned from the scandal at Wells Fargo?
2. In her book *The Seven Signs of Ethical Collapse,* Jennings explains: "When an organization collapses ethically, it means that those in the organization have drifted into rationalizations and legalisms, and all for the purpose of getting the results they want and need at almost any cost." Discuss what you think Jennings meant by this statement in the context of the "Giving Voice to Values" discussions in Chapter 2.
3. Explain the components of Burchard's Ethical Dissonance Model and how it describes the ethical person-organization fit at various stages of the contractual relationship in each potential fit scenario. Assume a *Low Organizational Ethics, High Individual Ethics (Low-High)* fit. How might this relationship influence your motivation to blow the whistle on corporate wrongdoing?
4. Explain the following statements: (1) It has been argued that an organization that does not support those that whistle blow because of violation of professional standards is indicative of a failure of organizational ethics; (2) It is a distinguishing mark of actions labeled whistleblowing that the agent intends to force attention to a serious moral problem. How does this statement relate to whistleblowers who come forward under provisions of the Dodd-Frank Financial Reform Act?

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5. In an interview on Philosophy Talk, a national syndicated radio program, Edward Snowden, the National Security Agency whistleblower, was asked whether he sees himself as a hero or a traitor, considering the various depictions presented by the government and media. He answered by discussing the cost-benefit analysis that whistleblowers must consider before leaking information. Use the Snowden case and analyze his actions from a cost-benefit perspective. How might Rights Theory lead to a different analysis?
6. Explain the role of integrity in workplace ethics.
7. According to the 2013 *National Business Ethics Survey,* 60% of workplace misconduct involved someone with managerial authority. Roughly 25% of observed misconduct involved senior managers. Why are high-level employees more likely to behave unethically?
8. It has been said that recent graduates from a business school majoring in accounting and just entering the profession are especially vulnerable to ethical missteps because they are often naive and may not see the ethical aspects of situations they confront. Explain the various dimensions of such alleged ethical challenges in the workplace.
9. Organizational culture can influence moral behavior through the "stacked deck" phenomenon. Explain how this might work and lead to a defense of subordinates' behavior we might call "They made me do it".
10. Do you believe that employees who observe more occupational fraud in their organizations are more likely to engage in occupational fraud themselves?
11. The following questions are about corporate governance and executive compensation:
    (a) How does agency theory address the issue of executive compensation?
    (b) How might stakeholder theory argue against the current model of executive compensation in the United States?
    (c) What is meant by the statement, "Compensation systems always become in part *end* and not simply *means*"?
12. The issue of the size of executive compensation packages is explored in the text. The highest paid CEO in 2016 was Thomas Rutledge, CEO of Charter Communications, who received $98 million in executive compensation. As noted in the text, critics claim that CEOs receive excessive executive compensation packages when compared with the average worker (271:1). How would you evaluate the fairness of executive compensation pay packages?
13. Explain how internal auditors' sensitivity to ethical dilemmas might be influenced by corporate governance mechanisms.
14. What are the roles and responsibilities of independent members of the board of directors with respect to risk management and corporate governance?
15. How can a board of directors know whether the culture of the organization supports the right kind of risk taking?
16. Five months before the new 2002 Lexus ES hit showroom floors, the company's U.S. engineers sent a test report to Toyota City in Japan: The luxury sedan shifted gears so roughly that it was "not acceptable for production." Days later, another Japanese executive sent an e-mail to top managers saying that despite misgivings among U.S. officials, the 2002 Lexus was "marginally acceptable for production." The new ES went on sale across the nation on October 1, 2001.

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In years to come, thousands of Lexus owners discovered that some of the vehicles had transmission problems, which caused it to hesitate when motorists hit the gas or lurch forward unintentionally. The 2002–2006 ES models would become the target of lawsuits, federal safety investigations, and hundreds of consumer complaints, including claims of 49 injuries.

In an August 15, 2005, memo explaining the company's position, a staff attorney wrote, "The objective will be to limit the number of vehicles to be serviced to those owners who complain and to limit the per-vehicle cost."

In 2010, Toyota was fined a record $16.4 million for delays in notifying U.S. federal safety officials about defects that could lead to sudden acceleration.

What are the common features in the automobile product defect cases discussed in the text and in this question? What role did corporate governance play in the way they were handled by management?

17. While on a lunch break following a dispute with a supervisor, an employee updated her Facebook status to an expletive and the name of the employer's company. Several coworkers "liked" her status. She later posted that the employer didn't appreciate its employees; no coworkers responded to this online. Do you believe the employee should be fired for her actions? Explain why or why not.

18. Brief and Motowidlo define prosocial behavior within the organizational setting as "behavior which is (a) performed by a member of an organization, (b) directed toward an individual, group, or organization with whom she interacts while carrying out her organizational role, and (c) performed with the intention of promoting the welfare of the individual, group, or organization toward which it is directed."[127]

    The researchers on whistleblowing using this model have generally argued that stages 5 and 6 represent cognitive moral development consistent with prosocial behavior. Discuss why stages 5 and 6 of Kohlberg's model are more likely to be associated with prosocial behavior than lower stages of moral development.

19. How do the concepts of cognitive dissonance and organizational/ethical dissonance relate to whether an accountant might choose to blow the whistle on corporate wrongdoing?

20. Just because an accountant or auditor has a right to blow the whistle, does that mean she has a duty to blow the whistle? How might we make that determination?

21. Review the facts related to the reporting of financial statement fraud by Tony Menendez at Halliburton in the context of the factors identified in the Anti-Fraud Collaboration study. Discuss the similarities between the two with respect to Menendez's experiences and explain how an effective compliance function might have been used to mitigate the concerns of reporting suspected fraud.

22. When financial results aren't what they seemed to be—and a company is forced to issue material financial restatements –should it be required to develop policies to claw back incentive pay and bonuses that were awarded to senior managers on the basis of rosier outcomes? Use ethical reasoning to answer this question.

23. Is it a positive result that 40% of occupational fraud is initially detected by a "tip"? Explain why or why not.

24. Do you believe the U.S. Supreme Court decision in *Digital Realty Trust, Inc. v. Somers* and the decision in *Erhart v. Bofl* holdings were the "right" decisions? Explain the basis for your answer.

25. Is business ethics an oxymoron?

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Chapter 3 Cases

Case 3-1 The Parable of the Sadhu

Bowen H. McCoy

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Last year, as the first participant in the new six-month sabbatical program that Morgan Stanley has adopted, I enjoyed a rare opportunity to collect my thoughts as well as do some traveling. I spent the first three months in Nepal, walking 600 miles through 200 villages in the Himalayas and climbing some 120,000 vertical feet. My sole Western companion on the trip was an anthropologist who shed light on the cultural patterns of the villages that we passed through.

During the Nepal hike, something occurred that has had a powerful impact on my thinking about corporate ethics. Although some might argue that the experience has no relevance to business, it was a situation in which a basic ethical dilemma suddenly intruded into the lives of a group of individuals. How the group responded holds a lesson for all organizations, no matter how defined.

The Sadhu

The Nepal experience was more rugged than I had anticipated. Most commercial treks last two or three weeks and cover a quarter of the distance we traveled.

My friend Stephen, the anthropologist, and I were halfway through the 60-day Himalayan part of the trip when we reached the high point, an 18,000-foot pass over a crest that we'd have to traverse to reach the village of Muklinath, an ancient holy place for pilgrims.

Six years earlier, I had suffered pulmonary edema, an acute form of altitude sickness, at 16,500 feet in the vicinity of Everest base camp—so we were understandably concerned about what would happen at 18,000 feet. Moreover, the Himalayas were having their wettest spring in 20 years; hip-deep powder and ice had already driven us off one ridge. If we failed to cross the pass, I feared that the last half of our once-in-a-lifetime trip would be ruined.

The night before we would try the pass, we camped in a hut at 14,500 feet. In the photos taken at that camp, my face appears wan. The last village we'd passed through was a sturdy two-day walk below us, and I was tired.

During the late afternoon, four backpackers from New Zealand joined us, and we spent most of the night awake, anticipating the climb. Below, we could see the fires of two other parties, which turned out to be two Swiss couples and a Japanese hiking club.

To get over the steep part of the climb before the sun melted the steps cut in the ice, we departed at 3.30 a.m. The New Zealanders left first, followed by Stephen and myself, our porters and Sherpas, and then the Swiss. The Japanese lingered in their camp. The sky was clear, and we were confident that no spring storm would erupt that day to close the pass.

At 15,500 feet, it looked to me as if Stephen was shuffling and staggering a bit, which are symptoms of altitude sickness. (The initial stage of altitude sickness brings a headache and nausea. As the condition worsens, a climber may encounter difficult breathing, disorientation, aphasia, and paralysis.) I felt strong—my adrenaline was flowing—but

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I was very concerned about my ultimate ability to get across. A couple of our porters were also suffering from the height, and Pasang, our Sherpa sirdar (leader), was worried.

Just after daybreak, while we rested at 15,500 feet, one of the New Zealanders, who had gone ahead, came staggering down toward us with a body slung across his shoulders. He dumped the almost naked, barefoot body of an Indian holy man—a sadhu—at my feet. He had found the pilgrim lying on the ice, shivering and suffering from hypothermia. I cradled the sadhu's head and laid him out on the rocks. The New Zealander was angry. He wanted to get across the pass before the bright sun melted the snow. He said, "Look, I've done what I can. You have porters and Sherpa guides. You care for him. We're going on!" He turned and went back up the mountain to join his friends.

I took a carotid pulse and found that the sadhu was still alive. We figured he had probably visited the holy shrines at Muklinath and was on his way home. It was fruitless to question why he had chosen this desperately high route instead of the safe, heavily traveled caravan route through the Kali Gandaki gorge. Or why he was shoeless and almost naked, or how long he had been lying in the pass. The answers weren't going to solve our problem.

Stephen and the four Swiss began stripping off their outer clothing and opening their packs. The sadhu was soon clothed from head to foot. He was not able to walk, but he was very much alive. I looked down the mountain and spotted the Japanese climbers, marching up with a horse.

Without a great deal of thought, I told Stephen and Pasang that I was concerned about withstanding the heights to come and wanted to get over the pass. I took off after several of our porters who had gone ahead.

On the steep part of the ascent where, if the ice steps had given way, I would have slid down about 3,000 feet, I felt vertigo. I stopped for a breather, allowing the Swiss to catch up with me. I inquired about the sadhu and Stephen. They said that the sadhu was fine and that Stephen was just behind them. I set off again for the summit.

Stephen arrived at the summit an hour after I did. Still exhilarated by victory, I ran down the slope to congratulate him. He was suffering from altitude sickness—walking 15 steps, then stopping, walking 15 steps, then stopping. Pasang accompanied him all the way up. When I reached them, Stephen glared at me and said, "How do you feel about contributing to the death of a fellow man?"

I did not completely comprehend what he meant. "Is the sadhu dead?" I inquired.

"No," replied Stephen, "but he surely will be!"

After I had gone, followed not long after by the Swiss, Stephen had remained with the sadhu. When the Japanese had arrived, Stephen had asked to use their horse to transport the sadhu down to the hut. They had refused. He had then asked Pasang to have a group of our porters carry the sadhu. Pasang had resisted the idea, saying that the porters would have to exert all their energy to get themselves over the pass. He believed they could not carry a man down 1,000 feet to the hut, reclimb the slope, and get across safely before the snow melted. Pasang had pressed Stephen not to delay any longer.

The Sherpas had carried the sadhu down to a rock in the sun at about 15,000 feet and pointed out the hut another 500 feet below. The Japanese had given him food and drink. When they had last seen him, he was listlessly throwing rocks at the Japanese party's dog, which had frightened him.

We do not know if the sadhu lived or died.

For many of the following days and evenings, Stephen and I discussed and debated our behavior toward the sadhu. Stephen is a committed Quaker with deep moral vision. He said, "I feel that what happened with the sadhu is a good example of the breakdown between the individual ethic and the corporate ethic. No one person was willing to assume ultimate responsibility for the sadhu. Each was willing to do his bit just so long as it was not too inconvenient. When it got to be a bother, everyone just passed the buck to someone else and took off. Jesus was relevant to a more individualistic stage of society, but how do we interpret his teaching today in a world filled with large, impersonal organizations and groups?"

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I defended the larger group, saying, "Look, we all cared. We all gave aid and comfort. Everyone did his bit. The New Zealander carried him down below the snow line. I took his pulse and suggested we treat him for hypothermia. You and the Swiss gave him clothing and got him warmed up. The Japanese gave him food and water. The Sherpas carried him down to the sun and pointed out the easy trail toward the hut. He was well enough to throw rocks at a dog. What more could we do?"

"You have just described the typical affluent Westerner's response to a problem. Throwing money—in this case, food and sweaters—at it, but not solving the fundamentals!" Stephen retorted.

"What would satisfy you?" I said. "Here we are, a group of New Zealanders, Swiss, Americans, and Japanese who have never met before and who are at the apex of one of the most powerful experiences of our lives. Some years the pass is so bad no one gets over it. What right does an almost naked pilgrim who chooses the wrong trail have to disrupt our lives? Even the Sherpas had no interest in risking the trip to help him beyond a certain point."

Stephen calmly rebutted, "I wonder what the Sherpas would have done if the sadhu had been a well-dressed Nepali, or what the Japanese would have done if the sadhu had been a well-dressed Asian, or what you would have done, Buzz, if the sadhu had been a well-dressed Western woman?"

"Where, in your opinion," I asked, "is the limit of our responsibility in a situation like this? We had our own well-being to worry about. Our Sherpa guides were unwilling to jeopardize us or the porters for the sadhu. No one else on the mountain was willing to commit himself beyond certain self-imposed limits."

Stephen said, "As individual Christians or people with a Western ethical tradition, we can fulfill our obligations in such a situation only if one, the sadhu dies in our care; two, the sadhu demonstrates to us that he can undertake the two-day walk down to the village; or three, we carry the sadhu for two days down to the village and persuade someone there to care for him."

"Leaving the sadhu in the sun with food and clothing—where he demonstrated hand-eye coordination by throwing a rock at a dog—comes close to fulfilling items one and two," I answered. "And it wouldn't have made sense to take him to the village where the people appeared to be far less caring than the Sherpas, so the third condition is impractical. Are you really saying that, no matter what the implications, we should, at the drop of a hat, have changed our entire plan?"

The Individual versus the Group Ethic

Despite my arguments, I felt and continue to feel guilt about the sadhu. I had literally walked through a classic moral dilemma without fully thinking through the consequences. My excuses for my actions include a high adrenaline flow, a superordinate goal, and a once-in-a-lifetime opportunity—common factors in corporate situations, especially stressful ones.

Real moral dilemmas are ambiguous, and many of us hike right through them, unaware that they exist. When, usually after the fact, someone makes an issue of one, we tend to resent his or her bringing it up. Often, when the full import of what we have done (or not done) hits us, we dig into a defensive position from which it is very difficult to emerge. In rare circumstances, we may contemplate what we have done from inside a prison.

Had we mountaineers been free of stress caused by the effort and the high altitude, we might have treated the sadhu differently. Yet isn't stress the real test of personal and corporate values? The instant decisions that executives make under pressure reveal the most about personal and corporate character.

Among the many questions that occur to me when I ponder my experience with the sadhu are: What are the practical limits of moral imagination and vision? Is there a collective or institutional ethic that differs from the ethics of the individual? At what level of effort or commitment can one discharge one's ethical responsibilities?

Not every ethical dilemma has a right solution. Reasonable people often disagree; otherwise there would be no dilemma. In a business context, however, it is essential that managers agree on a process for dealing with dilemmas.

Our experience with the sadhu offers an interesting parallel to business situations. An immediate response was mandatory. Failure to act was a decision in itself. Up on the mountain, we could not resign and submit our résumés to a

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headhunter. In contrast to philosophy, business involves action and implementation—getting things done. Managers must come up with answers based on what they see and what they allow to influence their decision-making processes. On the mountain, none of us but Stephen realized the true dimensions of the situation we were facing.

One of our problems was that, as a group, we had no process for developing a consensus. We had no sense of purpose or plan. The difficulties of dealing with the sadhu were so complex that no one person could handle them. Because the group did not have a set of preconditions that could guide its action to an acceptable resolution, we reacted instinctively as individuals. The cross-cultural nature of the group added a further layer of complexity. We had no leader with whom we could all identify and in whose purpose we believed. Only Stephen was willing to take charge, but he could not gain adequate support from the group to care for the sadhu.

Some organizations do have values that transcend the personal values of their managers. Such values, which go beyond profitability, are usually revealed when the organization is under stress. People throughout the organization generally accept its values, which, because they are not presented as a rigid list of commandments, may be somewhat ambiguous. The stories people tell, rather than printed materials, transmit the organization's conceptions of what is proper behavior.

For 20 years, I have been exposed at senior levels to a variety of corporations and organizations. It is amazing how quickly an outsider can sense the tone and style of an organization and, with that, the degree of tolerated openness and freedom to challenge management.

Organizations that do not have a heritage of mutually accepted, shared values tend to become unhinged during stress, with each individual bailing out for himself or herself. In the great takeover battles we have witnessed during past years, companies that had strong cultures drew the wagons around them and fought it out, while other companies saw executives—supported by golden parachutes—bail out of the struggles.

Because corporations and their members are interdependent, for the corporation to be strong, the members need to share a preconceived notion of correct behavior, a "business ethic," and think of it as a positive force, not a constraint.

As an investment banker, I am continually warned by well-meaning lawyers, clients, and associates to be wary of conflicts of interest. Yet if I were to run away from every difficult situation, I wouldn't be an effective investment banker. I have to feel my way through conflicts. An effective manager can't run from risk either; he or she has to confront risk. To feel "safe" in doing that, managers need the guidelines of an agreed-upon process and set of values within the organization.

After my three months in Nepal, I spent three months as an executive-in-residence at both the Stanford Business School and the University of California at Berkeley's Center for Ethics and Social Policy of the Graduate Theological Union. Those six months away from my job gave me time to assimilate 20 years of business experience. My thoughts turned often to the meaning of the leadership role in any large organization. Students at the seminary thought of themselves as antibusiness. But when I questioned them, they agreed that they distrusted all large organizations, including the church. They perceived all large organizations as impersonal and opposed to individual values and needs. Yet we all know of organizations in which people's values and beliefs are respected and their expressions encouraged. What makes the difference? Can we identify the difference and, as a result, manage more effectively?

The word *ethics* turns off many and confuses more. Yet the notions of shared values and an agreed-upon process for dealing with adversity and change—what many people mean when they talk about corporate culture—seem to be at the heart of the ethical issue. People who are in touch with their own core beliefs and the beliefs of others and who are sustained by them can be more comfortable living on the cutting edge. At times, taking a tough line or a decisive stand in a muddle of ambiguity is the only ethical thing to do. If a manager is indecisive about a problem and spends time trying to figure out the "good" thing to do, the enterprise may be lost.

Business ethics, then, has to do with the authenticity and integrity of the enterprise. To be ethical is to follow the business as well as the cultural goals of the corporation, its owners, its employees, and its customers. Those who cannot serve the corporate vision are not authentic businesspeople and, therefore, are not ethical in the business sense.

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At this stage of my own business experience, I have a strong interest in organizational behavior. Sociologists are keenly studying what they call corporate stories, legends, and heroes as a way organizations have of transmitting value systems. Corporations such as Arco have even hired consultants to perform an audit of their corporate culture. In a company, a leader is a person who understands, interprets, and manages the corporate value system. Effective managers, therefore, are action-oriented people who resolve conflict, are tolerant of ambiguity, stress, and change, and have a strong sense of purpose for themselves and their organizations.

If all this is true, I wonder about the role of the professional manager who moves from company to company. How can he or she quickly absorb the values and culture of different organizations? Or is there, indeed, an art of management that is totally transportable? Assuming that such fungible managers do exist, is it proper for them to manipulate the values of others?

What would have happened had Stephen and I carried the sadhu for two days back to the village and become involved with the villagers in his care? In four trips to Nepal, my most interesting experience occurred in 1975, when I lived in a Sherpa home in the Khumbu for five days while recovering from altitude sickness. The high point of Stephen's trip was an invitation to participate in a family funeral ceremony in Manang. Neither experience had to do with climbing the high passes of the Himalayas. Why were we so reluctant to try the lower path, the ambiguous trail? Perhaps because we did not have a leader who could reveal the greater purpose of the trip to us.

Why didn't Stephen, with his moral vision, opt to take the sadhu under his personal care? The answer is partly because Stephen was hard-stressed physically himself and partly because, without some support system that encompassed our involuntary and episodic community on the mountain, it was beyond his individual capacity to do so.

I see the current interest in corporate culture and corporate value systems as a positive response to pessimism such as Stephen's about the decline of the role of the individual in large organizations. Individuals who operate from a thoughtful set of personal values provide the foundation for a corporate culture. A corporate tradition that encourages freedom of inquiry, supports personal values, and reinforces a focused sense of direction can fulfill the need to combine individuality with the prosperity and success of the group. Without such corporate support, the individual is lost.

That is the lesson of the sadhu. In a complex corporate situation, the individual requires and deserves the support of the group. When people cannot find such support in their organizations, they don't know how to act. If such support is forthcoming, a person has a stake in the success of the group and can add much to the process of establishing and maintaining a corporate culture. Management's challenge is to be sensitive to individual needs, to shape them, and to direct and focus them for the benefit of the group as a whole.

For each of us, the sadhu lives. Should we stop what we are doing and comfort him, or should we keep trudging up toward the high pass? Should I pause to help the derelict I pass on the street each night as I walk by the Yale Club en route to Grand Central Station? Am I his brother? What is the nature of our responsibility if we consider ourselves to be ethical persons? Perhaps it is to change the values of the group so that it can, with all its resources, take the other road.

Questions

1. Throughout *The Parable of the Sadhu,* Bowen McCoy refers to the breakdown between the individual and corporate ethic. Explain what he meant by that and how, if we view the hikers on the trek up the mountain in Nepal as an organization, the ethical person-organization fit applied to the decisions made on the climb.
2. Using the various ethical discussions in the first three chapters as your guide, evaluate the actions of McCoy, Stephen, and the rest of the group from an ethical perspective.
3. What role did leadership and culture play in this case?
4. What is the moral of the story of the sadhu from your perspective?

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Case 3-2 Rite Aid Inventory Surplus Fraud

Occupational fraud comes in many shapes and sizes. The fraud at Rite Aid is one such case. In February 2015, VP Jay Findling pleaded guilty to fraud. VP Timothy Foster pleaded guilty to making false statements to authorities. On November 16, 2016, Foster was sentenced to five years in prison and Findling, four years. Findling and Foster were ordered to jointly pay $8,034,183 in restitution. Findling also forfeited and turned over an additional $11.6 million to the government at the time he entered his guilty plea. In sentencing Foster, U.S. Middle District Judge John E. Jones III expressed his astonishment that in one instance at Rite-Aid headquarters, Foster took a multimillion dollar cash pay-off from Findling, then stuffed the money into a bag and flew home on Rite Aid's corporate jet.[1]

The charges relate to a nine-year conspiracy to defraud Rite Aid by lying to the company about the sale of surplus inventory to a company owned by Findling when it was sold to third parties for greater amounts. Findling would then kick back a portion of his profits to Foster. Foster's lawyer told Justice Jones that, even though they conned the company, the efforts of Foster and Findling still earned Rite Aid over $100 million "instead of having warehouses filled with unwanted merchandise." Assistant U.S. Attorney Kim Daniel focused on the abuse of trust by Foster and persistent lies to the feds. "The con didn't affect some faceless corporation, Daniel said, "but harmed Rite Aid's 89,000 employees and its stockholders." Findling's attorney, Kevin Buchan, characterized his client as "a good man who made a bad decision." "He succumbed to the pressure. That's why he did what he did and that's why he's here," Buchan said during sentencing.

Findling admitted he established a bank account under the name "Rite Aid Salvage Liquidation" and used it to collect the payments from the real buyers of the surplus Rite Aid inventory. After the payments were received, Findling would send lesser amounts dictated by Foster to Rite Aid for the goods, thus inducing Rite Aid to believe the inventory had been purchased by J. Finn Industries, not the real buyers. The government alleged Findling received at least $127.7 million from the real buyers of the surplus inventory but, with Foster's help, only provided $98.6 million of that amount to Rite Aid, leaving Findling approximately $29.1 million in profits from the scheme. The government also alleged that Findling kicked back approximately $5.7 million of the $29.1 million to Foster.

Assume you are the director of internal auditing at Rite Aid and discover the surplus inventory scheme. You know that Rite Aid has a comprehensive corporate governance system that complies with the requirements of Sarbanes-Oxley, and the company has a strong ethics foundation. Moreover, the internal controls are consistent with the COSO framework. Explain the steps you would take to determine whether you would blow the whistle on the scheme applying the requirements of AICPA Interpretation 102-4 that are depicted in Exhibit 3.11. In that regard, answer the following questions.

Questions

1. Explain the following concepts in the context of the case and how it relates to individual and organizational factors that contribute to fraud:
   - Rationalizations for unethical actions.
   - Stakeholder effects.
   - Ethical dissonance.
   - Sometimes good people do bad things.
2. Assume you are the director of internal auditing and have uncovered the fraud. What would you do and why?
3. Assume, instead, that you are the audit engagement partner of KPMG and are the first to uncover the fraud. You approach management of the firm and discuss making the necessary adjustments. Top management tells you not to press the issue because the firm doesn't want to rock the boat with one of its biggest clients. What would you do and why?

[1] Matt Miller, Ex-Rite Aid VP, businessman, get years in federal prison for multimillion dollar scam, November 16, 2016, http://www.pennlive.com/news/2016/11/ex-rite_aid:vp_businessman_get.html.

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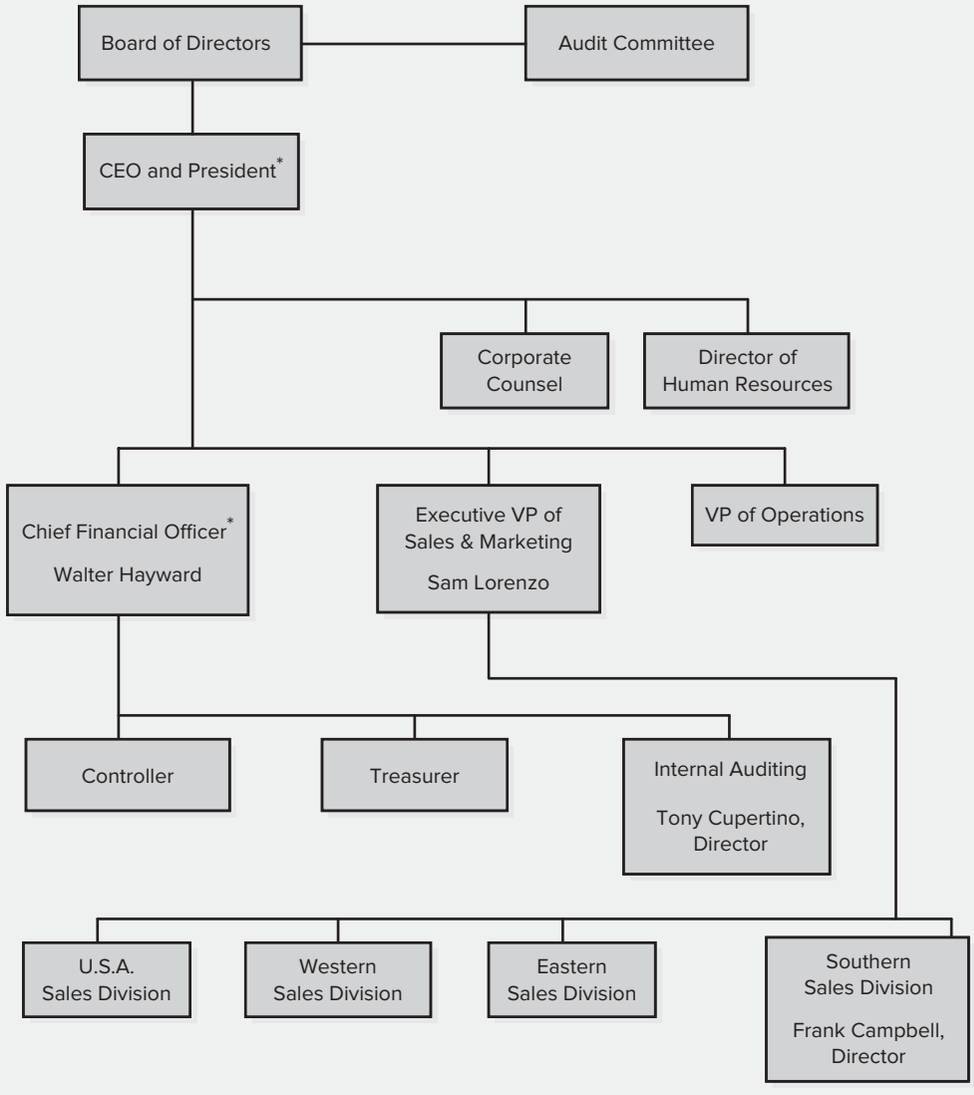
Case 3-3 United Thermostatic Controls (a GVV case)

United Thermostatic Controls is a publicly owned company that engages in the manufacturing and marketing of residential and commercial thermostats. The thermostats are used to regulate temperature in furnaces and refrigerators. United sells its product primarily to retailers in the domestic market, with the company headquartered in Detroit. Its operations are decentralized according to geographic region. As a publicly owned company, United's common stock is listed and traded on the NYSE. The organization chart for United is presented in Exhibit 1.

EXHIBIT 1 United Thermostatic Controls Organization Chart



*Member of the board of directors.

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Frank Campbell is the director of the Southern sales division. Worsening regional economic conditions and a reduced rate of demand for United's products have created pressures to achieve sales revenue targets set by United management nonetheless. Also, significant pressures exist within the organization for sales divisions to maximize their revenues and earnings for 2018 in anticipation of a public offering of stock early in 2019. Budgeted and actual sales revenue amounts, by division, for the first three quarters in 2018 are presented in Exhibit 2.

EXHIBIT 2 United Thermostatic Controls—Sales Revenue, 2018 (1st 3Qs)

	Budgeted and Actual Sales Revenue First Three Quarters in 2018					
	U.S.A. Sales Division			Western Sales Division		
Quarter Ended	Budget	Actual	% Var.	Budget	Actual	% Var.
March 31	$ 632,000	$ 638,000	.009%	$ 886,000	$ 898,000	.014%
June 30	640,000	642,000	.003	908,000	918,000	.011
September 30	648,000	656,000	.012	930,000	936,000	.006
Through September 30	$1,920,000	$1,936,000	.008%	$2,724,000	$2,752,000	.010%

	Eastern Sales Division			Southern Sales Division		
Quarter Ended	Budget	Actual	% Var.	Budget	Actual	% Var.
March 31	$ 743,000	$ 750,000	.009%	$ 688,000	$ 680,000	(.012)%
June 30	752,000	760,000	.011	696,000	674,000	(.032)
September 30	761,000	769,000	.011	704,000	668,000	(.051)
Through September 30	$2,256,000	$2,279,000	.010%	$2,088,000	$2,022,000	(.032)%

Campbell knows that actual sales lagged even further behind budgeted sales during the first two months of the fourth quarter. He also knows that each of the other three sales divisions exceeded their budgeted sales amounts during the first three quarters in 2018. He is very concerned that the Southern division has been unable to meet or exceed budgeted sales amounts. He is particularly worried about the effect this might have on his and the division managers' bonuses and share of corporate profits.

In an attempt to improve the sales revenue of the Southern division for the fourth quarter and for the year ended December 31, 2018, Campbell reviewed purchase orders received during the latter half of November and early December to determine whether shipments could be made to customers prior to December 31. Campbell knows that sometimes orders that are received before the end of the year can be filled by December 31, thereby enabling the division to record the sales revenue during the current fiscal year. It could simply be a matter of accelerating production and shipping to increase sales revenue for the year.

Reported sales revenue of the Southern division for the fourth quarter of 2018 was $792,000. This represented an 18.6% increase over the actual sales revenue for the third quarter of the year. As a result of this increase, reported sales revenue for the fourth quarter exceeded the budgeted amount by $80,000, or 11.2%. Actual sales revenue for the year exceeded the budgeted amount for the Southern division by $14,000, or 0.5%. Budgeted and actual sales revenue amounts, by division, for the year ended December 31, 2018, are presented in Exhibit 3.

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EXHIBIT 3 United Thermostatic Controls—Sales Revenue, 2018 (4 Qs)

	Budgeted and Actual Sales Revenue in 2018					
	U.S.A. Sales Division			Western Sales Division		
Quarter Ended	Budget	Actual	% Var.	Budget	Actual	% Var.
March 31	$ 632,000	$ 638,000	.009%	$ 886,000	$ 898,000	.014%
June 30	640,000	642,000	.003	908,000	918,000	.011
September 30	648,000	656,000	.012	930,000	936,000	.006
December 31	656,000	662,000	.009	952,000	958,000	.006
2018 Totals	$2,576,000	$2,598,000	.009%	$3,676,000	$3,710,000	.009%

	Eastern Sales Division			Southern Sales Division		
Quarter Ended	Budget	Actual	% Var.	Budget	Actual	% Var.
March 31	$ 743,000	$ 750,000	.009%	$ 688,000	$ 680,000	(.012)%
June 30	752,000	760,000	.011	696,000	674,000	(.032)
September 30	761,000	769,000	.011	704,000	668,000	(.051)
December 31	770,000	778,000	.010	712,000	792,000	.112
2018 Totals	$3,026,000	$3,057,000	.010%	$2,800,000	$2,814,000	.005%

During the course of their test of controls, the internal audit staff questioned the appropriateness of recording revenue of $150,000 on two shipments made by the Southern division in the fourth quarter of the year. These shipments are described as follows:

1. United shipped thermostats to Allen Corporation on December 31, 2018, and billed Allen $85,000, even though Allen had specified a delivery date of no earlier than February 1, 2019, to take control of the product. Allen intended to use the thermostats in the heating system of a new building that would not be ready for occupancy until March 1, 2019.
2. United shipped thermostats to Bilco Corporation on December 30, 2018, in partial (one-half) fulfillment of an order. United recorded $65,000 revenue on that date. Bilco had previously specified that partial shipments would not be accepted. Delivery of the full shipment had been scheduled for February 1, 2019.

During their investigation, the internal auditors learned that Campbell had pressured United's accounting department to record these two shipments early to enable the Southern division to achieve its goals with respect to the company's revenue targets. The auditors were concerned about the appropriateness of recording the $150,000 revenue in 2018 in the absence of an expressed or implied agreement with the customers to accept and pay for the prematurely shipped merchandise. The auditors noted that, had the revenue from these two shipments not been recorded, the Southern division's actual sales for the fourth quarter would have been below the budgeted amount by $70,000, or 9.8%. Actual sales revenue for the year ended December 31, 2018, would have been below the budgeted amount by $136,000, or 4.9%. The revenue effect of the two shipments in question created a 5.4% shift in the variance between actual and budgeted sales for the year. The auditors felt that this effect was significant with respect to the division's revenue and earnings for the fourth quarter and for the year ended December 31, 2018. The auditors decided to take their concerns to Tony Cupertino, director of the internal auditing department. Cupertino is a licensed CPA.

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Cupertino discussed the situation with Campbell. Campbell informed Cupertino that he had received assurances from Sam Lorenzo, executive vice president of sales and marketing, that top management would support the recording of the $150,000 revenue because of its strong desire to meet or exceed budgeted revenue and earnings amounts. Moreover, top management is very sensitive to the need to meet financial analysts' consensus earnings estimates. According to Campbell, the company is concerned that earnings must be high enough to meet analysts' expectations because any other effect might cause the stock price to go down. In fact, Lorenzo has already told Campbell that he did not see anything wrong with recording the revenue in 2018 because the merchandise had been shipped to the customers before the end of the year and the terms of shipment were FOB shipping point.

At this point, Cupertino is uncertain whether he should take his concerns to Walter Hayward, the CFO, who is also a member of the board of directors, or take them directly to the audit committee. Cupertino knows that the majority of the members of the board, including those on the audit committee, have ties to the company and members of top management. Cupertino is not even certain that he should pursue the matter any further because of the financial performance pressures that exist within the organization. However, he is very concerned about his responsibilities as a CPA and obligations to work with the external auditors who will begin their audit in a few weeks. It is at this point that Cupertino learns from Campbell that the CFO of Bilco agreed to accept full shipment when the goods arrive in return for a 20% discount on the total price that would be paid on February 1, 2019. Cupertino asked Campbell how he had found out. It seems Campbell took the initiative to help solve the revenue problem by going directly to the Bilco CFO.

Questions

1. Identify the stakeholders in this case and their interests.
2. Describe the ethical and professional responsibilities of Tony Cupertino.
3. Assume you are in Cupertino's position and know you have to do something about the improper accounting in the Southern sales division. Consider the following in crafting a plan how best to voice your values and take appropriate action:
   - How can you get it done effectively and efficiently?
   - What do you need to say, to whom, and in what sequence?
   - What will the objections or pushback be, and then,
   - What would you say next? What data and other information do you need to make your point and counteract the reasons and rationalizations you will likely have to address?

Case 3-4 Franklin Industries' Whistleblowing (a GVV Case)

Natalie got the call she had been waiting for over six long months. Her complaint to the human resources department of Franklin Industries had been dismissed. It was HR's conclusion that she was not retaliated against for reporting an alleged embezzlement by the Accounting Department manager. In fact, HR ruled there was no embezzlement at all. Natalie had been demoted from assistant manager of the department to staff supervisor seven months ago after informing Stuart Masters, the controller, earlier in 2018, about the embezzlement. Her blood started to boil as she thought about all the pain and agony she'd experienced these past six months without any level of satisfaction for her troubles.

Natalie Garson is a CPA who works for Franklin Industries, a publicly owned company and manufacturer of trusses and other structural components for home builders throughout the United States. Six months ago she filed a complaint with HR after discussing a sensitive matter with her best friend and coworker, Roger Harris. Natalie trusted Harris, who had six years of experience at Franklin. The essence of the discussion was that Natalie was informed

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by the accounting staff of what appeared to be unusual transactions between Denny King, the department manager, and an outside company no one had ever heard of before. The staff had uncovered over $5 million in payments, authorized by King, to Vic Construction. No one could find any documentation about Vic, so the staff dug deeper and discovered that the owner of Vic Construction was Victoria King. Further examination determined that Victoria King and Denny King were siblings.

Once Natalie was convinced there was more to the situation than meets the eye, she informed the internal auditors, who investigated and found that Vic Construction made a $5 million electronic transfer to a separate business owned by Denny King. One thing lead to another, and it was determined by the internal auditors that King had funneled $5 million to Vic Construction, which, at a later date, transferred the money back to King. It was a $5 million embezzlement from Franklin Industries.

Natalie met with Roger Harris that night and told him about the HR decision that went against her. She was concerned whether the internal auditors would act now in light of that decision She knew the culture at Franklin was "don't rock the boat." That didn't matter to her. She was always true to her values and not afraid to act when a wrongdoing had occurred. She felt particularly motivated in this case—it was personal. She felt the need to be vindicated. She hoped Roger would be supportive.

As it turned out, Roger cautioned Natalie about taking the matter any further. He had worked for Franklin a lot longer than Natalie and knew the board of directors consisted mostly of insider directors. The CEO of Franklin was also the chair of the board. It was well known in the company that whatever the CEO wanted to do, the board rubber-stamped it.

Natalie left the meeting with Roger wondering whether she was on her own. She knew she had to act but didn't know the best way to go about it. Even though Roger cautioned against going to the CEO or board, Natalie didn't dismiss that option.

Questions

Assume you are in Natalie's position. Answer the following questions.

1. What are the ethical values in this case? What about professional values?
2. Consider the following assuming you have decided to do something about the embezzlement:
   - What are the main arguments you are trying to counter? That is, what are the reasons and rationalizations you need to address?
   - What is at stake for the key parties, including those who disagree with you?
   - What levers can you use to influence those who disagree with you?
   - What is your most powerful and persuasive response to the reasons and rationalizations you need to address? To whom should the argument be made? When and in what context?
3. Assume you have exhausted all your options within Franklin Industries. Is this a situation where you would consider filing a complaint with the SEC under the Sarbanes-Oxley Act? What about Dodd-Frank? Explain.

Case 3-5 Walmart Inventory Shrinkage (a GVV Case)

The nation's retailers lost a staggering amount of money in 2016 due to shoplifting, organized crime, internal theft, and other types of inventory shrink.

Inventory shrink totaled $48.9 billion in 2016, up from $45.2 billion the year before, as budget constraints left retail security budgets flat or declining, according to the annual National Retail Security Survey by the National Retail Federation and the University of Florida. The thefts amounted to 1.44% of sales, up from 1.38%.

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According to the study,[1] which was sponsored by The Retail Equation, 48.8% of retailers surveyed reported increases in inventory shrink, and 16.7% said it remained flat. Shoplifting and organized retail crime accounted for 36.5% of shrink, followed by employee theft/internal (30%), administrative paperwork error (21.3%), and vendor fraud or error (5.4%).

Shoplifting continued to account for the greatest losses of overall shrink. Shoplifting averaged $798.48 per incident, up from $377 in 2015. The rise was partially attributed to retailers allocating smaller budgets for loss prevention, leaving them with fewer security staff to fight theft, the report said.

The average loss due to employee theft per incident was put at $1,922.80, up from $1,233.77 in 2015. The average cost of retail robberies dropped to $5,309.72 from $8,170.17 in 2015, but remained at more than double the $2,464.50 seen in 2014.

For the first time in the survey, retailers were asked about return fraud, reporting an average loss of $1,766.27.

The facts of this case are from the Walmart shrinkage fraud discussed in an article in *The Nation* on June 11, 2014. "Literary license" has been exercised for the purpose of emphasizing important issues related to organizational ethics at Walmart. Any resemblance to actual people and events is coincidental.[2]

Shane O'Hara always tried to do the right thing. He was in touch with his values and always tried to act in accordance with them, even when the going got tough. But nothing prepared him for the ordeal he would face as a Walmart veteran and the new store manager in Atomic City, Idaho.

In 2013, Shane was contacted by Jeffrey Cook, the regional manager, and told he was being transferred to the Atomic City store in order to reduce the troubled store's high rate of "shrinkage" (i.e., theft including shoplifting and employees stealing) to levels deemed acceptable by the company's senior managers for the region. As a result of fierce competition, profit margins in retail can be razor thin, making shrinkage a potent—sometimes critical—factor in profitability. Historically, Walmart had a relatively low rate of about 0.8% of sales. The industry average was 1%.

Prior to his arrival at the Atomic City store, Shane had heard the store had shrinkage losses as high as $2 million or more—a sizable hit to its bottom line. There had even been talk of closing the store altogether. He knew the pressure was on to keep the store open, save the jobs of 40 people, and cut losses so that the regional manager could earn a bonus. It didn't hurt that he would qualify for a bonus as well, so long as the shrinkage rate was cut by more than two-thirds.

Shane did what he could to tighten systems and controls. He managed to convince Cook to hire an "asset-protection manager" for the store. The asset-protection program handles shrink, safety, and security at each of its stores. The program worked. Not only did shrinkage decline but other forms of loss, including changing price tags on items of clothing, were significantly reduced.

However, it didn't seem to be enough to satisfy Cook and top management. During the last days of August 2013, Shane's annual inventory audit showed a massive reduction in the store's shrinkage rate that surprised even him: down to less than $80,000 from roughly $800,000 the previous year. He had no explanation for it, but was sure the numbers had been doctored in some way.

During the remainder of 2013, a number of high-level managers departed from the company. Cindy Rondel, the head of Walmart's Idaho operations, retired; so did her superior, Larry Brooks. Walmart's regional asset-protection manager for Idaho, who was intimately involved with inventory tracking in the state, was fired as well. Shane wondered if he was next.

Shane decided to contact Cook to discuss his concerns. Cook explained why the shrinkage rate had shrunk so much by passing it off as improper accounting at the Atomic City store that had been corrected. He told Shane that an

[1] Marianne Wilson, Retailers losing billions to inventory, June 22, 2017, https://www.chainstoreage.com/article/retailers-losing-billions-inventory-shrink/.

[2] Spencer Woodman, "Former Managers Allege Pervasive Inventory Fraud at Walmart: How Deep Does the Rot Go?" *The Nation,* June 11, 2014.

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investigation would begin immediately and he was suspended with pay until it was completed. Shane was in shock. He knew the allegations weren't true. He sensed he might become the fall guy for the fraud.

Shane managed to discretely talk about his situation with another store manager in the Atomic City area. That manager said she had been the target of a similar investigation the year before. In her case, she had discovered how the fraud was carried out and the numbers were doctored, but she had told no one—until now.

She explained to Shane that the fraud involved simply declaring that missing items were not, in fact, missing. She went on to say you could count clothing items in the store and if the on-hand count was off—as in, you were supposed to have 12 but you only had 10—you could explain that the other 2 were in a bin where clothing had been tried on by customers, not bought, and left in the dressing room, often with creases that had to be cleaned before re-tagging the clothing for sale. So, even though some items may have been stolen, they were still counted as part of inventory. There was little or no shrinkage to account for.

At this point Shane did not know what his next step should be. He needed to protect his good name and reputation. But what steps should he take? That was the question.

Questions

Assume you are in Shane O'Hara's position. Answer the following questions.

1. Put on "Your Thinking Cap" and explain how the provisions of the Sarbanes-Oxley Act might have helped to detect the fraud.
2. What anti-fraud controls might have helped detect the fraud. Why?
3. Assume you are in Shane O'Hara's position. What would you do next and why? Consider the following in crafting your response.
   - Who are the stakeholders in this case and what are the ethical issues?
   - What do you need to say, to whom, and in what sequence?
   - What are the reasons and rationalizations you are likely to hear in getting your point across?
   - What is your most powerful and persuasive response to these arguments? To whom should you make them? When and in what context?
4. Is this a situation where you would seriously consider blowing the whistle since you were suspended with pay? Under what conditions would you blow the whistle and what process might you follow?

Case 3-6 Full Disclosure: The Case of the Morally Challenged AP Clerk (a GVV case)

John Stanton, CPA, is a seasoned accountant who left his Big-4 CPA firm Senior Manager position to become the CFO of a highly successful hundred million-dollar privately held manufacturer of solar panels. The company wanted John's expertise in the renewable energy sector and his pedigree from working for one of the Big-4 firms. The company plans to go public later this year and wants John to lead the effort. Everything went well for the first two months until the controller, Diane Hopkins, who is also a CPA, came to John with a problem. She discovered that one of her accounts payable clerks has been embezzling money from the company by processing and approving fictitious invoices from shell companies for fictitious purchases that the AP clerk had created. Diane estimated that the clerk had been able to steal approximately $250,000 over the year and a half they worked at the company. Diane and John agreed to fire the clerk immediately and did so. They also agreed that John would report the matter to the police.

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John picked up the phone and called the CEO, David Laskey, who was also the majority shareholder, to give him a heads up on what had transpired. Laskey asked John to come to his office the next day to discuss the need to report the matter to the police. Laskey shared with John that he did not think it was a good idea to report it to the police as he was fearful of the effect on taking the company public and the initial public offering share price.

After the call, John reflected on what it would mean to not report the matter to the police and whether there were others he needed to inform about the matter.

Questions

1. To whom do John Stanton and David Laskey owe their ultimate responsibility? Explain.
2. If Stanton were to agree not to report this embezzlement to the police or disclose it in the annual report and prospectus, would he be violating the integrity or due care rule in the AICPA Code of Professional Conduct? What about acts discreditable?
3. Assume Stanton is preparing for the meeting with Laskey. Consider the following in deciding what he should do.
   - What can he say to Laskey to counteract the reasons Laskey provided not to notify the police?
   - Who can Stanton rely on for support in this matter? What might he say to that person(s) to encourage their support?
   - What levers can Stanton use to convince Laskey as to the correct course of action given the company's impending IPO?
   - What should Stanton do next if Laskey orders him to drop the matter?

Case 3-7 Olympus

Summary of the Case[1]

On September 25, 2012, Japanese camera and medical equipment maker Olympus Corporation and three of its former executives pleaded guilty to charges related to an accounting scheme and cover-up in one of Japan's biggest corporate scandals. Olympus admitted that it tried to conceal investment losses by using improper accounting under a scheme that began in the 1990s.

The scandal was exposed in 2011 by Olympus's then-CEO, Michael C. Woodford. As the new president of Olympus, he felt obliged to investigate the matter and uncovered accounting irregularities and suspicious deals involving the acquisition of U.K. medical equipment manufacturer Gyrus. He called the company's auditors, PwC, to report it. The firm examined payments of $687 million related to financial advice on the acquisition paid to a non-existent Cayman Islands firm. A fraud of $1.7 billion emerged, including an accounting scandal to hide the losses. Along the way, the Japanese way of doing business came under attack by Woodford.

Olympus initially said that it fired Woodford, one of a handful of foreign executives at top Japanese companies, over what it called his aggressive Western management style. Woodford disclosed internal documents to show he was dismissed after he raised questions about irregular payouts related to mergers and acquisitions. Without any serious attempt by management to investigate, he went behind the board's back and commissioned a report by PwC into the Gyrus deal, including the unusually high advisory fee and apparent lack of due diligence. On October 11, 2011, he circulated the report to the board and called on the chair of the board, Tsuyoshi Kikukawa, and executive vice president Hisashi Mori to resign. Three days later, the board fired Woodford.

[1]The facts of this case are drawn from: Michael Woodford, *Exposure: Inside the Olympus Scandal: How I Went from CEO to Whistleblower* (NY: Penguin Books, 2012).

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Ultimately, the accounting fraud was investigated by the Japanese authorities. "The full responsibility lies with me, and I feel deeply sorry for causing trouble to our business partners, shareholders, and the wider public," Kikukawa told the Tokyo district court. "I take full responsibility for what happened."

Prosecutors charged Kikukawa, Mori, and a former internal auditor, Hideo Yamada, with inflating the company's net worth in financial statements for five fiscal years up to March 2011 due to accounting for risky investments made in the late-1980s bubble economy. The three former executives had been identified by an investigative panel, commissioned by Olympus, as the main suspects in the fraud. In December 2011, Olympus filed five years' worth of corrected financial statements plus overdue first-half results, revealing a $1.1 billion hole in its balance sheet.

On April 28, 2017, following six years of scandal-ridden disclosures, a Tokyo court found Kikukawa and five others liable for $529 million. Kikukawa and two other executives who pleaded guilty never went to jail. Instead, they were given suspended sentences of up to three years.

Olympus Spent Huge Sums on Inflated Acquisitions, Advisory Fees to Conceal Investment Losses

Olympus's cover-up of massive losses has shed light on several murky methods that some companies employed to clean up the mess left after Japan's economic bubble burst. Many companies turned to speculative investments as they suffered sluggish sales and stagnant operating profits. The company used "loss-deferring practices" to make losses look smaller on the books by selling bad assets to related companies.

To take investment losses off its books, Olympus spent large sums of money to purchase British medical equipment maker Gyrus Group PLC and three Japanese companies and paid huge consulting fees. Olympus is suspected of having deliberately acquired Gyrus at an inflated price, and, in the year following the purchase, it booked impairment losses as a result of decreases in the company's value.

To avert a rapid deterioration of its financial standing, Olympus continued corporate acquisitions and other measures for many years, booking impairment losses to improve its balance sheet. Losses on the purchases of the three Japanese companies amounted to $34.5 billion. With money paid on the Gyrus deal included, Olympus may have used more than $62.5 billion in funds for past acquisitions to conceal losses on securities investments.

The previous method that recorded stocks and other financial products by book value—the price when they were purchased—was abolished. The new method listed them by market value (mark-to-market accounting). Under this change, Olympus had to report all the losses in its March 2001 report. However, Olympus anticipated this change a year in advance and posted only about $10.6 billion of the nearly $62.5 billion as an extraordinary loss for the March 2000 settlement term. The company did not post the remainder as a deficit; rather, it deferred it using questionable measures.

Olympus's Tobashi Scheme

At the heart of Olympus's action was a once-common technique to hide losses called *tobashi,* which Japanese financial regulators tolerated before clamping down on the practice in the late 1990s. *Tobashi,* translated loosely as "to blow away," enables companies to hide losses on bad assets by selling those assets to other companies, only to buy them back later through payments, often disguised as advisory fees or other transactions, when market conditions or earnings improve.

Tobashi allows a company with the bad assets to mask losses temporarily, a practice banned in the early 2000s. The idea is that you pay off the losses later, when company finances are better.

Olympus appears to have pushed to settle its *tobashi* amounts from 2006 to 2008, when the local economy was picking up and corporate profits were rebounding, in an effort to "clean up its act." Business was finally strong enough to be able to withstand a write-down. It was during those years that the company engineered the payouts that came under scrutiny: $687 million in fees to an obscure financial adviser over Olympus's acquisition of Gyrus in 2008, a

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fee that was roughly a third of the $2 billion acquisition price, more than 30 times the norm. Olympus also acquired three small Japanese companies from 2006 to 2008 with little in common with its core business for a total of $773 million, only to write down most of their value within the same fiscal year.

Olympus Scandal Raises Questions about the "Japan Way" of Doing Business

The scandal rocked corporate Japan, not least because of the company's succession of firings, denials, admissions, and whistleblowing. It also exposed weaknesses in Japan's financial regulatory system and corporate governance.

"This is a case where Japan's outmoded practice of corporate governance remained and reared its ugly head," according to Shuhei Abe, president of Tokyo-based Sparx Group Company. "With Olympus's case, it will no longer be justifiable for Japan Inc. to continue practicing under the excuse of the 'Japan way of doing things.'"

On the surface, Olympus seemed to have checks on its management. For example, it hired directors and auditors from outside the company, as well as a British president who was not tied to corporate insiders. In reality, however, the company's management was ruled by former chairman Kikukawa and a few other executives who came from its financial sections.

The company's management is believed to have been effectively controlled by several executives who had a background in financial affairs, including Kikukawa and Mori, both of whom were involved in the cover-up of past losses. Olympus's board of auditors, which is supposed to supervise the board of directors, included full-time auditor Hideo Yamada, who also had financial expertise.

After Woodford made his allegations, he was confronted by a hostile board of directors that acted based on the premise that whistleblowing offended their corporate culture. Subsequently, the board fired him saying that he had left because of "differences in management styles." Employees were warned not to speak to him or jeopardize their careers.

One problem with corporate governance in Japan is truly independent non-executive directors are unusual. Many Japanese do not see the need for such outside intervention. They question how outsiders can know enough about the company to make a valuable contribution. Moreover, how could they be sensitive to the corporate culture? They could even damage the credibility of the group.

Accounting Explanations

Olympus hid a $1.7 billion loss through an intricate array of transactions.

A one-paragraph summary of what it did appears in the investigation report:

> The lost disposition scheme is featured in that Olympus sold the assets that incurred loss to the funds set up by Olympus itself, and later provided the finance needed to settle the loss under the cover of the company acquisitions. More specifically, Olympus circulated money either by flowing money into the funds by acquiring the entrepreneurial ventures owned by the funds at the substantially higher price than the real values, or by paying a substantially high fee to the third party who acted as the intermediate in the acquisition, resulting in recognition of a large amount of goodwill, and subsequently amortized goodwill recognized impairment loss, which created substantial loss.

Here is a more understandable version of the event:

> Olympus indirectly loaned money to an off-the-books subsidiary and then sold the investments that had the huge losses to the subsidiary at historical cost, eventually paying a huge premium to buy some other small companies and writing off the underwater investments as if they were goodwill impairments.

A more detailed bookkeeping analysis of the complicated transactions appears in Exhibit 1.

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EXHIBIT 1 Detailed Bookkeeping Analysis of Olympus's Accounting Fraud[2]

PHASE 1

Transaction 1:

This is a summary of a complex move—it involved purchasing a certificate of deposit (CD) at several banks that were asked to loan the money back to an unrelated entity, with the CD as collateral, so the subsidiary can buy investments from Olympus.

Note: According to the investigative committee's report, three banks were involved through the course of the whole project: Commerzbank, LGT, and Société Générale. The committee's report indicates that all three banks agreed to Olympus's request not to tell the auditors about the CDs being collateral for a loan.

(Olympus books)

DR Certificate of deposit
CR Cash
(CD purchase at banks; banks loan it to unconsolidated subsidiary)

(Unconsolidated subsidiary books)

DR Cash
CR Note payable to banks
(Cash from banks; collateralized by Olympus)

Transaction 2:

(Olympus books)

DR Cash
CR Financial assets (Investments)
(Proceeds from selling underwater investments to unconsolidated subsidiary; may have triggered gain on sale)

(Unconsolidated subsidiary books)

DR Financial assets (Investments)
CR Cash
(To buy underwater investments from Olympus)

PHASE 2

Eventually the CDs would have to be rolled over and brought back. In addition, the unrealized losses would have to be written down eventually, so the second phase was launched.

Transaction 3:

Olympus bought some tiny (startup) companies. It paid significantly more than they were worth and paid large amounts for consultants for their service as finders and intermediaries.

(Olympus books)

DR Investments (startup subsidiary)
DR Goodwill—(cash paid less fair market value of subsidiary net assets)
CR Cash
(Investments in new subsidiaries)

(*Continued*)

[2] "Olympus Scandal: $1.5 billion in Losses Hidden in Dodgy Acquisitions," Available at http://factsanddetails.com/japan/cat24/sub157/item2305.html.

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Note: The investment in the consolidated subsidiary shows a large amount of goodwill, which could then be written down.

(Entries by the newly formed consolidated subsidiary)

DR Cash
CR Common stock
(Cash investment from Olympus)

Transaction 4:

The effect of these transactions was to transfer money into the newest consolidated subsidiary, which used the money to buy the bad investments from the older, unconsolidated subsidiary. The unconsolidated subsidiary then repaid the note payable to the bank and Olympus liquidated its CD.

(Entries by the newly formed consolidated subsidiary)

DR Financial assets (Investments)
CR Cash
(Buy underwater investments from unconsolidated subsidiary at book value)

(Unconsolidated subsidiary books)

DR Cash (from consolidated subsidiary)
CR Financial assets (Investments)
(Proceeds received from consolidated subsidiary from sale of underwater investments)
DR Note payable to banks
CR Cash
(Repay loan to banks)

Entries by Olympus

DR Cash
CR Certificate of deposit
(CD liquidated)

*Olympus Scandal: $1.5 billion in Losses Hidden in Dodgy Acquisitions.

Auditor Responsibilities

Arthur Andersen was the external auditor through March 31, 2002, after which Andersen closed its doors for good in the post-Enron era. Then KPMG AZSA LLC was the auditor through March 31, 2009. The 2010 and 2011 fiscal years were audited by Ernst & Young ShinNihon LLC.

The investigative report noted that the fraud was hidden quite well. Three banks were involved in hiding information from the auditors. The summary report said that all three of them agreed not to tell auditors the information that would normally be provided on an audit confirmation.

KPMG did come across one of the *tobashi* schemes carried out through one of the three different routes that had been set up. According to the investigative report:

Not everything was going smoothly. The report said that in 1999, Olympus's then-auditor, KPMG AZSA LLC, came across information that indicated the company was engaged in *tobashi,* which recently had become illegal in Japan. Mori and Yamada initially denied KPMG's assertion, but the auditor pushed them that same year to admit to the presence of one fund and unwind it, booking a loss of $10.5 billion. The executives assured KPMG that that was the

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only such deal, the report said. However, the schemes expanded, without detection, for another six years or so and was in place, without detection, until the last component was unwound at the end of fiscal year 2010. The last part of the bad investments was finally written off in March 2011.

Olympus Finally Had Enough of the Deception

Olympus removed KPMG AZSA as its group auditor in 2009 after a dispute over how to account for some controversial acquisitions. The camera-maker decided not to disclose this to the stock market. Instead, Olympus told investors at the time that KPMG's audit contract had expired and it was hiring Ernst & Young. Mori and Yamada had finally decided to unwind and write off the underwater financial assets and repay the loans that Olympus had made through its unconsolidated subsidiary. Of course, by then, the financial press had gotten wind of what was going on at Olympus.

Questions

1. What role did cultural relativism and situational ethics play in the Olympus fraud? Explain.
2. Describe the shortcomings in corporate culture at Olympus?
3. Did Michael Woodford violate his ethical and/or legal responsibilities as CEO of Olympus? Use the U.S. model of corporate governance to answer this question.
4. Compare the accounting techniques used by Olympus with those used by Enron. What was each designed to do? How did each affect financial reporting? Does it seem the auditors of Olympus should have done more to fully disclose these transactions?

Case 3-8 Accountant Takes on Halliburton and Wins!

The whistleblowing aspects of this case were first discussed in the text. What follows is a more comprehensive discussion of accounting and auditing issues.

In 2005, Tony Menendez, a former Ernst & Young LLP auditor and director of technical accounting and research training for Halliburton, blew the whistle on Halliburton's accounting practices. The fight cost him nine years of his life. Just a few months later in 2005, Menendez received an e-mail from Mark McCollum, Halliburton's chief accounting officer, and a top-ranking executive at Halliburton, that also went to much of the accounting department. "The SEC has opened an inquiry into the allegations of Mr. Menendez," it read. Everyone was to retain their documents until further notice.

What happened next changed the life of Menendez and brought into question how such a large and influential company could have such a failed corporate governance system. Further, the role of the auditors, KPMG, with respect to its handling of accounting and auditing matters seemed off, and independence was an issue. Exhibit 1 summarizes some of the relevant accounting and auditing issues in the case.

Nature of Halliburton's Revenue Transactions in Question

During the months following the "leaked" e-mail, Menendez waited and watched to see if Halliburton would act on his claims that the company was cooking the books. The issue was revenue recognition as discussed following.

Halliburton enters into long-term contracts with energy giants like Royal Dutch Shell or BP to find and exploit huge oil and gas fields. It sells services—the expertise of its geologists and engineers. Halliburton also builds massive and expensive machinery that its professionals use to provide those services. Then, the company charges its

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EXHIBIT 1 Issues Related to the Sarbanes-Oxley Act, SEC, and KPMG

Tony Menendez contacted Halliburton's audit committee because he believed it was in the best interest of the employees and shareholders if he made himself available to the committee in its efforts to investigate the questionable accounting and auditing practices and properly respond to the SEC. It was discovered that Halliburton did not have in place, as required by Section 301 of the Sarbanes-Oxley Act (SOX), a process for "(1) the receipt and treatment of complaints received by the issuer regarding accounting, internal controls, or auditing matters; and (2) the confidential, anonymous submission of employees of the issuer of concerns regarding questionable accounting or auditing matters."

After waiting for the company to take action to no avail, Menendez felt there was no alternative to blowing the whistle, and on November 4, 2005, he contacted the SEC and PCAOB stating in part:

"As a CPA and the Director of Technical Accounting Research and Training for Halliburton, I feel it is my duty and obligation to report information that I believe constitutes both a potential failure by a registered public accounting firm, KPMG, to properly perform an audit and the potential filing of materially misleading financial information with the SEC by Halliburton."

Two weeks later, at the agencies' request, he met with SEC enforcement staff at their Fort Worth office. On November 30, 2005, he approached members of top management of Halliburton. On February 4, 2006, Menendez provided what he believed would be a confidential report to Halliburton's audit committee, giving the company yet another opportunity for self-examination. However, on the morning of February 6, 2006, Menendez's identity was disclosed to Mark McCollum, Halliburton's chief accounting officer, and less than an hour after finding out that Menendez had reported the questionable accounting and auditing practices to the SEC, McCollum distributed information about Menendez's investigation and identity.

The disclosure was followed by a series of retaliatory actions. Halliburton management stripped Menendez of teaching and researching responsibilities, ordered subordinates to monitor and report on his activity, excluded him from meetings and accounting decisions, and ordered financial and accounting personnel to pre-clear any conversations about accounting issues before discussing them with Menendez.

In May 2005, Menendez filed a civil whistleblower complaint under SOX. In July 2006, Halliburton told the Department of Labor committee handling the case that KPMG had insisted that Menendez be excluded from a meeting concerning accounting for a potential joint venture arrangement called "RTA." Halliburton indicated it acceded to KPMG's demand and excluded Menendez from the meeting. SOX prohibits an employer from discriminating against an employee, contractor, or agent and from prohibiting such party from engaging in activity protected under the Act, and the SEC stated that the assertion by the company that KPMG's presence was mandatory was misleading. In fact, the SEC opined that KPMG's presence was not even advisable since KPMG was supposed to be an independent auditor in both appearance and in fact.

The RTA meeting was scheduled to determine whether or not Halliburton would be required to consolidate the proposed joint venture. Senior management explicitly stated that the division management would not receive approval to proceed unless Halliburton could both avoid consolidation and maintain control over the joint venture activities. Earlier in the development of the accounting position regarding this joint venture, KPMG told management that it would allow the company to avoid consolidation and FIN 46R's Anti-Abuse criteria on the basis that the determination required professional judgment, and indicated that KPMG would be willing to support a conclusion that Halliburton was not significantly involved in the joint venture activities, when clearly the facts and circumstances did not support such a conclusion. Menendez had vehemently objected to KPMG and management's proposed conclusion on the basis that such a position was absurd.

According to the SEC, given KPMG's previous guidance to the company regarding RTA, and its willingness to accommodate unsupportable conclusions, continued input by KPMG on RTA was inappropriate and, once again, put KPMG in the position of auditing its own recommendations and advice. In the end, the concerted failures of management and the external auditor underscored the lack of independence between company and KPMG, which was a root cause of the accounting violations Menendez fought to correct and, at last, had to report.

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customers for that equipment, which has particularly high profit margins. At the crux of the matter, the company's accountants had been allowing the company to count the full value of the equipment right away as revenue, sometimes even before it had assembled the equipment. But the customers could walk away in the middle of the contracts. Menendez realized that if the equipment were damaged, Halliburton, not the customer, was on the hook.

Menendez accused Halliburton of using so-called bill-and-hold techniques that distort the timing of billions of dollars in revenue and allowed Halliburton to book product sales before they occurred.

Menendez explained Halliburton's accounting this way:

> For example, the company recognizes revenue when the goods are parked in company warehouses, rather than delivered to the customer. Typically, these goods are not even assembled and ready for the customer. Furthermore, it is unknown as to when the goods will be ultimately assembled, tested, delivered to the customer, and, finally, used by the company to perform the required oilfield services for the customer.

Based on Menendez's claims, Halliburton's accounting procedures violated generally accepted accounting principles. For companies to recognize revenue before delivery, "the risks of ownership must have passed to the buyer," the SEC's staff wrote in a 2003 accounting bulletin. There also "must be a fixed schedule for delivery of the goods" and the product "must be complete and ready for shipment" among other things.

Shortly after joining Halliburton in March 2005, Menendez said he discovered a "terribly flawed" flow chart on the company's in-house Web site, called the Bill and Hold Decision Tree. The flow chart, a copy of which Menendez included in his complaint, walks through what to do in a situation where a "customer has been billed for completed inventory which is being stored at a Halliburton facility."

First, it asks: Based on the contract terms, "has title passed to customer?" If the answer is no—and here's where it gets strange—the employee is asked: "Does the transaction meet all of the 'bill-and-hold' criteria for revenue recognition?" If the answer to that question is yes, the decision tree says to do this: "Recognize revenue." The decision tree didn't specify what the other criteria were.

In other words, Halliburton told employees to recognize revenue even though the company still owned the product. Ironically, the accelerated revenue for financial statement purposes led to higher income taxes paid to the IRS.

"The policy in the chart is clearly at odds with generally accepted accounting principles," said Charles Mulford, a Georgia Institute of Technology accounting professor, who reviewed the court records. "It's very clear cut. It's not gray."

According to the accounting rules, it is possible to use bill-and-hold and comply with the rules. But it's hard. The customer, not the seller, must request such treatment. The customer also must have a compelling reason for doing so. Customers rarely do.

Top Halliburton accounting executives had agreed with Menendez's analysis, including McCollum, the company's chief accounting officer. But according to Menendez, they dragged their feet on implementing a change that was certain to slow revenue growth. In an e-mail response to detailed questions, a Halliburton spokeswoman wrote, "The accounting allegations were made by Mr. Menendez almost nine years ago and were promptly reviewed by the company and the Securities and Exchange Commission. The company's accounting was appropriate and the SEC closed its investigation." This seems curious when we examine the SEC's own rules for recognition.

Hocus Pocus Accounting: Bill-and-Hold Schemes

The proper accounting for Halliburton's bill-and-hold transactions was not lost on its external auditors, KPMG. In fact, in early 2005, KPMG published an article entitled: *Bill and Hold Transactions in the Oilfield Services Industry,*

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which made it clear that oilfield services companies had to comply with all four criteria of SEC Staff Accounting Bulletin (SAB 101) to recognize revenue early. These include:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred or services have been rendered.
- The seller's price to the buyer is fixed or determinable.
- Collectibility is reasonably assured.

KPMG went on to recognize that it would be rare for an oilfield services company to actually meet the necessary criteria. The impact to Halliburton was highlighted by KPMG's recognition that bill-and-hold transactions for oilfield services companies were "common" and "involve very large and complex products and equipment that carry significant amounts of economic value." KPMG went on to state that "perhaps no area of revenue recognition has received as much scrutiny as bill-and-hold."

Menendez's Complaint to the DOL

Menendez's allegations are part of a 54-page complaint he filed against Halliburton with a Department of Labor (DOL) administrative-law judge in Covington, Louisiana, who released the records to Menendez in response to a Freedom of Information Act request. Menendez claimed Halliburton retaliated against him in violation of the Sarbanes-Oxley Act's whistleblower provisions after he reported his concerns to the SEC and the company's audit committee.

According to a company spokesperson, Halliburton's audit committee "directed an independent investigation" and "concluded that the allegations were without merit." She declined to comment on bill-and-hold issues, and Halliburton's court filings in the case don't provide any details about its accounting practices.

Menendez filed his complaint shortly after a DOL investigator in Dallas rejected his retaliation claim. His initial claim was rejected by the court and subsequently appealed after many years, and the decision was ultimately overturned, but not until after he and his family had endured a nine year ordeal during which time he was an outcast at Halliburton.

The Final Verdict Is In: Accountant Takes on Halliburton and Wins!

The appeals process went on for three years. In September 2011, the administrative-law appeals panel ruled. It overturned the original trial judge. After five years, Menendez had his first victory.

But it wasn't over. Halliburton appealed to the Fifth Circuit Court of Appeals. There were more legal filings, more hours of work, more money spent.

Finally, in November 2014, almost nine years after Menendez received "The E-mail," he prevailed. The appeals panel ruled that he indeed had been retaliated against for blowing the whistle, just as he had argued all along.

Because he had wanted only to be proven right, he'd asked for a token sum. The administrative-law panel, noting the importance of punishing retaliations against whistleblowers, pushed for an increase and Menendez was awarded $30,000.

To say that the outcome stunned experts is something of an understatement. "Accountant beats Halliburton!" said Thomas, the attorney and expert on whistleblower law. "The government tries to beat Halliburton and loses."

Post-Decision Interview about Whistleblowing

In an interview with a reporter, Menendez offered that Halliburton had a whistleblower policy prior to this incident as required under Sarbanes-Oxley. It was required to be confidential, and although Halliburton's policy promised confidentiality, at the same time it discouraged anonymous complaints on the basis that if you didn't provide your

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identity, the company might not be able to properly investigate your concern. Menendez added that confidentiality was absolutely central to his case and he relied on this policy, but it was Halliburton that blatantly ignored its own policy and betrayed his trust.

He was asked how the whistleblowing policy of the SEC might be improved. He said that all too often it is almost impossible for a whistleblower to prevail and that there needs to be more protections and a more balanced playing field. "It shouldn't take nine years and hundreds of thousands of dollars to even have a remote chance of prevailing," he said.

The Human Aspect of the Case

Menendez felt he had to leave Halliburton because of the retaliation and how everyone treated him differently after the e-mail. During the appeals process, as Menendez and his wife waited for vindication and money got tight, he finally caught a break. Through the accounting experts he had met during his legal odyssey, he heard that General Motors was looking for a senior executive.

He agonized over whether to tell interviewers about his showdown with Halliburton. Ultimately, he figured they would probably find out anyway. When he flew up to Detroit and met with Nick Cypress, GM's chief accounting officer and comptroller, he came clean. Cypress had heard good things about Menendez from Doug Carmichael, the accounting expert who had been Menendez's expert witness at trial.

After telling him, Menendez asked Cypress, "Does this bother you?"

"Hell no!" the GM executive replied.

This was not the typical reaction top corporate officers have to whistleblowers. The interviewer asked Cypress about it: "I was moved by it," he explained. "It takes a lot of courage to stand tall like that, and I needed that in the work we were doing. I needed people with high integrity who would work hard who I could trust" to bring problems directly to senior management.

Today, Tony Menendez, is a litigation consultant, speaker and writer at Financial Fraud Examiner LLC. In the meantime, Halliburton has thrived. The SEC never levied any penalty for the accounting issue raised by Menendez. In 2014, the company generated $3.5 billion in profit on $33 billion in revenue. It's not possible to tell if the company maintains the same revenue recognition policy from its public filings, says GT professor Mulford. But since the SEC passed on an enforcement action on the issue, the company likely feels it is in accordance with accounting rules. (Mulford believes that Menendez was right back then and that the SEC should have looked harder at the issue initially.)

Many of the Halliburton and KPMG officials involved in the accounting issue or the retaliation have continued to prosper in the corporate ranks. One is now Halliburton's chief accounting officer. McCollum is now the company's executive vice president overseeing the integration of a major merger. The KPMG executive who disagreed with Menendez is now a partner at the accounting firm.

Menendez did not tell his friends and family of his legal victory. He's more cautious than he used to be. "I changed a lot. It was almost 10 years where everything was in question. Wondering what would people think of you."

He and his wife still worry that disaster could arrive in the next e-mail. "It can really weaken a soul and tear apart a family or a marriage, if you aren't careful. Because of the enormous powers of a company," said his wife. If people asked her advice, she said, "I'd probably say don't do it."

Recently, Menendez finally explained the story to his son, Cameron, who is now 13 and old enough to understand. Cameron's response: "You should have asked for more money, Dad," the teenager said. "We could use it."

Years ago, Menendez and his wife bought a bottle of champagne to celebrate his eventual victory. They still haven't opened it.

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Questions

1. Describe the inadequacies in the corporate governance system at Halliburton.
2. Consider the role of KPMG in the case with respect to the accounting and auditing issues. How did the firm's actions relate to the ethical and professional expectations for CPAs by the accounting profession?
3. The Halliburton case took place before the Dodd-Frank Financial Reform Act was adopted by Congress. Assume Dodd-Frank had been in effect and Menendez decided to inform the SEC under Dodd-Frank rather than SOX because it had been more than 180 days since the accounting violation had occurred. Given the facts of the case would Menendez have qualified for whistleblower protection? Explain.
4. Some critics claim that while Menendez's actions may have been courageous, he harmed others along the way. His family was in limbo for many years and had to deal with the agony of being labeled a whistleblower and disloyal to Halliburton. The company's overall revenue did not change; a small amount was merely shifted to an earlier period. Halliburton didn't steal any money, cheat the IRS, or cheat their customers or their employees. In fact, it lessened its cash flows by paying out taxes earlier than it should have under the rules.

   How do you respond to these criticisms?

Case 3-9 Loyalty to the Boss, Company, and/or the Profession: Whistleblowing as a Lever (a GVV Case)

Jerry Maloney, CPA has been working at Mason Pharmaceuticals for fifteen years. Mason is a Fortune 1000 company whose stock trades on the New York Stock Exchange. He came to Mason after starting his career in the Audit practice of PwC working on clients in the Pharmaceuticals and Medical Device manufacturing industries. Jerry loves and is very loyal to both the industry he works in and the company he works for. He believes that the drugs they manufacture save lives and he is committed to the continued success of the company. He started out as an Assistant Manager of Internal Audit at Mason, later led the internal audit division, and then moved into the Financial Reporting Department. His hard work has paid off and he was recently promoted to Senior Manager of Financial Reporting, reporting directly to the CFO. His department is responsible for preparing and ensuring the accuracy of all the required filings to the SEC and the NYSE. While his boss must certify the accuracy of the financials, the CFO relies on Jerry to ensure compliance with GAAP and that all the reporting requirements of the SEC and the NYSE are followed.

Jerry is sitting in his office reviewing a preliminary draft of the 10Q for the third quarter ended September 30, 2018. He is smiling as he reads the report as their Earnings Per Share (EPS) figures have exceeded their projected numbers for the third quarter in a row and he knows upper management will be thrilled. As he sits and contemplates what this might mean in terms of bonuses, raises, and stock valuation, Sharon Diggins, the Manager of Financial Reporting, knocks on his door. He invites her in and she explains that their staff have just found a material understatement of expenses in the draft 10Q. She explains that Research and Development Costs had been inadvertently capitalized as direct materials inventory and they needed to reverse that entry before issuing a final 10Q with the SEC. The reversal will cause them to fall just short of their expected EPS figures.

Mason had a big win in gaining regulatory approval for an impressive new treatment for Colorectal Cancer. The company expects this new drug to produce more revenue than any drug they have manufactured to date. Sharon explains that some manager in purchasing had inadvertently purchased a six months supply of the primary compound needed to produce the drug a month before regulatory approval was received. Unfortunately, the compound was received just a week before regulatory approval was granted. The accounts payable clerk recorded the invoice

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for the compound as Direct Materials Inventory as the intent was to use the materials for the manufacture of the new drug. Under GAAP all such costs need to be expensed as Research and Development Costs up until regulatory approval is received.

Jerry is distraught over the fact that the internal audit department did not catch this error sooner. He discusses with Sharon that they will need to investigate the oversight later but right now their larger issue is getting the reports revised. He explains that convincing John Bender, the CFO, that they need to correct this error now will be difficult. Bender is also reviewing the same draft of the 10Q that Jerry has and must be delighted by the apparent results. Jerry is sure he will argue against expensing the cost of the compound. He can just imagine that at a minimum Bender will argue that following GAAP to the letter does not make sense. The intent of the purchase was to produce the drug, which they will do starting in the current quarter. He is sure Bender will state following GAAP will actually reduce the true cost of goods sold next quarter and, therefore, they should leave the cost in inventory. Sharon reminds Jerry that a violation of GAAP of this magnitude would be considered fraudulent financial reporting by the SEC and cannot be allowed to happen. She suggests that they put their GVV training to work and try to identify all the arguments that Bender will use to try and convince them to ignore this error and then prepare counter arguments. Jerry agrees and they get to work formulating their plan for discussing this matter with Bender.

Questions

1. What are the main arguments that Jerry and Sharon will need to counter? That is, what are the reasons and rationalizations they will need to address?
2. What is at stake should they not convince Bender to issue a revised 10Q?
3. What levers do Jerry and Sharon have available to them? Include in your answer a discussion of the provisions under SOX and how they might be used as a lever.
4. If they cannot convince Bender to issue the revised report, what is their next step? To whom should they report this matter to? Include other parties they might be able to involve who will support their position.
5. If they are unable to stop the draft report from being issued, what are their options?

Case 3-10 Accountability of Ex-HP CEO in Conflict of Interest Charges

How could a CEO and chairperson of the board of directors of a major company resign in disgrace over a personal relationship with a contractor that led to a sexual harassment charge and involved a conflict of interest, a violation of the code of ethics? It happened to Mark Hurd on August 10, 2010. Hurd was the former CEO for Hewlett-Packard (HP) for five years and also served as the chair of the board of directors for four years. On departure from HP, Hurd said he had not lived up to his own standards regarding trust, respect, and integrity.

HP hired Playboy model Jodie Fisher to be a hostess at several HP events in California. Fisher was paid $30,000 to appear at six events, plus she received other benefits like first-class travel. The purpose of these events was for Mark Hurd to sell HP to chief information officers of other companies. On one occasion, Hurd invited Fisher up to his room, fondled her breasts, and asked her to stay the night. On another, he went to her room and forcibly kissed her. To gain her favor, over the next two years he passed her inside information, showed her his ATM balance of one million dollars, and suggested he'd take care of her if she'd go away with him. At an event in Boise, Idaho, Hurd tried one last time to force her into having sex, but Fisher ran away to her room and never worked again for HP.

The board of directors of HP began an investigation of Hurd in response to a sexual harassment complaint by Fisher, who retained lawyer Gloria Allred to represent her.

While HP did not find that the facts supported the complaint, they did reveal behavior that the board would not tolerate. Subsequent to Hurd's resignation, a severance package was negotiated granting Hurd $12.2 million, COBRA benefits, and stock options, for a total package of somewhere between $40 and $50 million.

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In a letter to employees of HP on August 6, interim CEO Cathie Lesjak outlined where Hurd violated the "Standards of Business Conduct (SBC)" and the reasons for his departure.[1] Lesjak wrote that Hurd "failed to maintain accurate expense reports, and misused company assets." She indicated that each was a violation of the standards and "together they demonstrated a profound lack of judgment that significantly undermined Mark's credibility and his ability to effectively lead HP." The letter reminded employees that everyone was expected to adhere strictly to the standards in all business dealings and relationships and senior executives should set the highest standards for professional and personal conduct.

As for the complaint by Fisher, it was pointed out she was a "marketing consultant" who was hired by HP for certain projects, but she was never an employee of HP. Still, during the investigation, inaccurately documented expenses were found that were claimed to have been paid to Fisher for her services. Falsifying the use of company funds violated the HP's Standards of Business Conduct (SBE).

As for the sexual harassment claim, Allred alleged in the letter that Hurd harassed Fisher at meetings and dinners over a several year period during which time Fisher experienced a number of unwelcome sexual advances from Hurd, including kissing and grabbing. Fisher said that this continual sexual harassment made her uncertain about her employment status.

In August 2013, HP and former CEO, Mark Hurd, won dismissal of a lawsuit that challenged the computer maker's public commitment to ethics at a time when Hurd was allegedly engaging in sexual harassment.

HP did not violate securities laws despite making statements such as a commitment to be "open, honest, and direct in all our dealings" because such statements were too vague and general, U.S. District Judge Jon Tigar in San Francisco wrote.

As a result, shareholders led by a New York City union pension fund could not pursue fraud claims over Hurd's alleged violations of HP's SBC, the judge ruled.

"Adoption of the plaintiff's argument [would] render every code of ethics materially misleading whenever an executive commits an ethical violation following a scandal," Tigar wrote.

Shareholders led by the Cement & Concrete Workers District Council Pension Fund of Flushing, New York, claimed in their lawsuit that the share price had been fraudulently inflated because of Hurd's alleged activities.

They also claimed that HP's statements about its rules of conduct implied that Hurd was in compliance, and that Hurd ignored his duty to disclose violations.

At most, Judge Tigar said, such statements "constitute puffery—if the market was even aware of them."

Tigar also said Hurd's alleged desire to keep his dealings with Fisher secret did not by itself give rise to a fraud claim.

"Nothing suggests that Hurd thought that he could mislead investors with the statements the court finds were immaterial," the judge wrote.

Shareholders filed multiple derivative claims in the wake of the scandal, all of which were settled. HP made some promises regarding compliance and ethics, improving ethics and compliance training programs, and strengthening HP's SBC. HP also promised to appoint a "Lead Independent Director" tasked with implementing and enforcing the ethics standards and appointing a chief ethics and compliance officer to report violations of the code. It also promised to appoint and Ethics and Compliance Committee to oversee HP's ethics activities, including in regard to whistleblowing.[2]

[1] Craig E. Johnson, *Meeting the Ethical Challenges of Leadership: Casting Light or Shadow* (New York: Sage Publications, 2015).

[2] Ex-HP CEO Mark Hurd Wins Fraud Suit Arising Out of Sexual Harassment, February 3, 2107, http://mimesislaw.com/fault-lines/ex-hp-ceo-mark-hurd-wins-fraud-suit-arising-out-of-his-sexual-harassment-scandal/15878.

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Questions

1. How can companies best protect themselves from claims of sexual harassment in the workplace?
2. How did the expenditures mentioned in the case affect the financial results at HP? Did financial fraud occur during the time Fisher was involved with Mark Hurd? Should their relationship have been disclosed to the shareholders? Explain.
3. Mark Hurd left HP with a compensation package between $40 million and $50 million. Do you think executives who resign from their positions or are fired because of unethical actions should be forced to give back some of those amounts to the shareholders to make them whole? Why or why not?
4. Despite hundreds of pages of policies, codes of ethics, organizational values, and carefully defined work environments and company culture, lapses in workplace ethics occur every day. Explain why you think these lapses occur and what steps might be taken by an organization to ensure that its top executives live up to values it espouses.

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